where comparable questions were asked. Survey results are parenthetically referenced below by descriptive initials (i.e., SRC or CBA).

The average consumer borrower is between 35 and 49 years of age (CBA). The borrower's household income equals or exceeds $44,000 (CBA/SRC). That borrower has worked for the same employer for 8 years, owned a home for over 9 (CBA), and tends to be better educated than the average homeowner (SRC). Less than 10% of the households surveyed by SRC had either applied for or held a HELC. Finally, of the 80% of homeowners surveyed who acknowledged their availability, ninetenths indicated no intention of opening a HELC in the near future (SRC).

The maturity and deliberation of the borrowing public is further reflected in HELC usage patterns. The most frequently mentioned reason for borrowing was for home improvements (CBA/SRC). Debt consolidation was the second most frequently mentioned reason (CBA/SRC). About 5% of the financial institutions cited major purchases, personal investments or educational expenses as the most frequent uses of borrowed funds (CBA). Finally, 31% of HELC borrowers indicated no account usage to date, more than half reported no use in the preceding six months and one-fifth had used their accounts just once (SRC).

Creditors surveyed substantiated this sobriety in usage patterns. The average creditor held $11,800,000 in approved lines but only $6,800,000 in actual HELC outstandings (CBA). Only one-fifth of all home equity borrowers surveyed indicated that they had used more than half of their credit line (SRC). Creditors offering variable rate HELCs indicate that their typical borrower has drawn down no more than 57% of the available credit line (CBA).

The deliberation and prudence with which borrowers approach HELC borrowing is matched by that of creditors granting those privileges. While the maximum loan-to-value ratio used by the average creditor is 76%, the average variable rate HELC is granted at a loan-to-value factor of less than 70% (CBA). In fact, this conservative ratio includes both first mortgage debt and the approved HELC (CBA). Further, if you look only at present outstandings (as opposed to approved HELCs), this factor shrinks to only 57% (CBA)! The effective result of these factors is that the average variable rate HELC equals less than 1/2 of the total home equity of the average homeowner (CBA).* We also note that over 70% of variable rate HELC approvals are based either on a full appraisal or municipal tax assessment (CBA). Finally, most creditors reported strict credit review procedures on at least an annual periodic basis after opening a HELC relationship (CBA).

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* The appraised value of the average house was $84,975, and the outstanding balance on the first mortgage was $34,989, leaving average total available equity of $49,986 (CBA).

Ultimately, the care and conservatism with which borrowers approach HELC usage and creditors address HELC lending is nowhere better reflected than in the low rates of HELC delinquency and foreclosure. The rate of HELC delinquencies is more than 30% less than that of all consumer credit (CBA). About 1% of all HELCs were delinquent (over 30 days) in 1986, as compared to 1.5% of all consumer debt (other than unsecured credit cards) (CBA). Inclusion of credit card delinquencies would expand this differential appreciably. Also, only 14 of the 302 institutions surveyed reported any foreclosures in 1986! This represented approximately 1.5 foreclosures per reporting institution.

This evidence suggests that consumers and creditors are treating the HELC relationship with the utmost respect and caution. Neither homeowners nor creditors are profligate with respect to the usage or provision of this consumer financial service. Substantive restrictions to protect homeowners from an alleged propensity for irresponsible behavior, whether their own or that attributed to the financial institutions with which they deal, are neither necessary or justifiable. No patterns of abuse can be documented at this time nor does the evidence suggest that they will be in the future.

In fact, in addition to prudent lending practices, HELC providers have taken a further pro-consumer stance by providing credit-shopping and educational guidelines to both their financial services colleagues and to consumers generally. Consumer education pamphlets and shopping guides have been produced and disseminated nationwide.

CBA itself has produced a consumer pamphlet for its members to use. It has met with unparalleled demand (an excerpt is attached as Appendix A). To date, CBA has given several thousand copies of the brochure directly to consumers across the country, pursuant to requests generated by related publicity. In addition, CBA has issued approximately 100,000 copies to its members as a customer relations tool. CBA has also made camera-ready copies available to more than a dozen members for in-house reproduction and dissemination. One such CBA member plans a public distribution of 50,000 customized pamphlets.

The pro-active efforts underscore the industry's commitment to the responsible and informed usage of HELCs. These efforts refute directly consumerist charges of reckless promotions centering on inducements to luxury or frivolous expenditures.

Similarly, they refute related charges of insufficient HELC disclosure and shopping information. Consumers simply have not found there to be a lack of HELC information in the marketplace. More than 90% of the HELC account holders interviewed by SRC reported that they had received all of the information they needed before they opened their HELC. More than 35% of those account holders said that they had considered an alternative source of credit, a clear indicator of comparison shopping capability and one that accords with Federal Reserve studies of actual credit shopping experience for all forms of consumer credit.*

This is not to say that improvements in the disclosure area cannot be made. However, based on the analyses of consumer usage patterns, delinquency and default rates, and industry credit granting practices and educational efforts, we submit that there is simply no evidence of need for the imposition of substantive restrictions on HELC practices.

II. New Disclosure Scheme Must Be Simple, Consistent With Existing Law And Not Redundant

If Congress deems it necessary to provide for additional consumer protection in this area, it should be limited to the types of application stage disclosures proposed in H.R. 3011 by Congressman Price. We firmly believe that the kinds of intrusive, substantive restrictions proposed by Congressman Schumer in H.R. 3468 are neither necessary nor warranted at this juncture.

In particular, CBA must state its strong and unwavering opposition to any efforts aimed at imposing specific pricing restraints on HELC practices. Whether framed as interest rate caps, loan-to-value ratios or overly restrictive initial discount, rate change or call limitations, they would prove harmful to consumers, by limiting HELC availability to a select few of the least risky customers. Specific artificial pricing restraints would also have an anticompetitive effect on the HELC marketplace, forcing creditors out of the market and acting as a disincentive to remaining HELC providers to respond to market forces dictating varied terms beneficial to consumers.

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* For example, see the Annual Percentage Rate Demonstration Project, Board of Governors of the Federal Reserve System, March 1987, p 29.

For these and other reasons, Congress has never passed specific interest rate or other pricing restrictions for consumer credit,[*] electing instead to provide for the timely dissemination of credit shopping information to consumers. Congress has trusted the free market to regulate prices. We respectfully urge that Congress not deviate from this well-reasoned and time-tested approach.

Subject to certain modifications, the Price bill would compliment the traditional congressional approach to this issue. It seeks to provide consumers with key credit terms at an early stage of the lending relationship without imposing undue burdens on creditor operations. As mentioned above, existing law already requires that consumers be given comprehensive disclosures and a three-business day right to cancel the account relationship before they can access an HELC. So the question is what additional disclosures should be given to consumers.

In answering this question, some guiding principles must be kept in mind. First, Congress must be wary of duplicating the detailed information required by existing law.[**] A corollary to this principle is the need to keep additional disclosures simple. Finally, the detailed initial disclosure and right of rescission formulas in present Truth-in-Lending law must not be disturbed.

The Price bill largely incorporates these principles by focusing on important HELC features and opting for their conspicuous, segregated disclosure at the application stage.

At Appendix C of this testimony, CBA has recommended for your consideration further refinements to H.R. 3011 which are consistent with its objectives and would facilitate the practical operation of this early disclosure scheme. These recommendations in most instances address issues generic to any scheme of additional disclosures in this area. Accordingly, they may constitute a useful point of reference for this Subcommittee's members and staffers.

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[*] Section 1204 of the recently enacted Competitive Equality Banking Act of 1987, P.L. 100-86, contains an interest rate cap requirement for all variable rate loans secured by one-to-four family dwellings but does not provide for a specific limitation.

[**] These requirements are reviewed at length in Part III of our testimony.

III. There is a Wealth of Existing Disclosure Law and Consumer Protections

Should Congress elect to provide for additional disclosures in this area, it is imperative tha the new requirements be framed with due consideration of the vast array of federal and state consumer protection laws presently applicable to home equity credit. Consideration must also be accorded to regulatory movement to fine-tune those laws which is presently underway.

Let us review briefly the major existing constraints, to show how much discipline already exists in the home equity credit market.

A. Just this past July, Congress mandated -- in Section 1204 of the Competitive Equality Banking Act of 1987 (P.L. 100-86) -- that creditors must include interest rate caps in all variable-rate, dwelling-secured consumer credit transactions. This includes conventional closed-end second mortgages, as well as the more recent pattern of HELCs secured by the consumer's home.

In its proposed regulations to implement that law (52 FR 34811, September 15, 1987), the Federal Reserve Board has taken a broad view of the legislative intent. For example, the proposal covers fixed-rate transactions if the creditor reserves the right to change terms as well as transactions with explicit rate adjustment features. Thus one suggested weakness of home equity credit -- the absence of contractual rate limitations -- will soon disappear. And if creditors now must include rate caps in the contract, they can be expected to compete for customers by offering more favorable limitations.

B. The federal Truth-in-Lending Act (TILA)* contains a time-proven regimen for advertising about home equity credit. TILA also requires detailed sets of transactional disclosures that reflect the differences between closed-end and open-end credit formats, and between variable-rate and fixed-rate terms. In open-end transactions in particular, consumers receive disclosures before the account is opened, and periodic reminders of the status of the account, balances owing, payments due, and applicable rates and terms. The TILA initial disclosures must include "clear and conspicuous" references to any security interest and to the property serving as collateral. The chart attached as Appendix B details all of these disclosure requirements.

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* 15 USC 1601 et. seq

Not only do home equity credit consumers receive extensive disclosures, but home equity transactions are subject to the right of rescission. This means that a consumer having second thoughts about the transaction can cancel it at no cost within 3 business days. This right of rescission was originally included in the Truth in Lending Act of 1968 precisely to protect consumers from unwitting or improvident encumbrances on their homes, which is the newly expressed concern about home equity credit. In this regard, the law anticipated the problem by nearly twenty years.

Truth-in-Lending has been a dynamic law, and the Federal Reserve Board has not hesitated to adjust the rules where necessary to deal with new practices. The Board is monitoring home equity credit practices carefully and has stated its concerns as to the need for regulatory strengthening in this area. In response, the Board staff has indicated that a comprehensive proposal for new home equity disclosures under Regulation Z will be presented to the Board in early December, 1987.*

The TILA rules on disclosure and rescission are reinforced by state disclosure laws (that may expand the terms to be disclosed), and by federal and state laws prohibiting false advertising and deceptive and unfair practices. Finally, the basic tenets of contract law require the lender to explicitly state its rights in the loan agreement.

In short, consumers have ample opportunity under existing law to learn the details of the transaction, and to consider cancelling it. While keeping an open-mind on initiatives like the Price bill, we must point out that refinements in these rules are being addressed and may be accomplished at the regulatory level without new legislation.

C. Other explicit federal law may enhance the protection of consumers entering into home equity transactions. For example, savings institutions offering variable rate credit under regulations of the Federal Home Loan Bank Board (12 CFR § 545.33 (1987)) already provide multi-page disclosures, and the Consumer Handbook on Adjustable Rate Mortgages, at the time of the consumer's application. These

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* At an open meeting of the Board of Governors of the Federal Reserve System on November 5, 1987, the Board staff indicated that they were presently refining on a package of proposed amendments to the open-end credit provisions of Regulation Z specifically dealing with home equity lending. This work was undertaken at the request of both the Board and the Board's Consumer Advisory Council. Balloon payments, acceleration or call provisions, and payment schedule disclosures are some of the subjects to be covered by the package of proposed amendments.

disclosures constitute a full exposition of a creditor's HELC plans, their terms, and their arithmetic. These FHLBB regulations also control substantive provisions in the home equity transaction, such as rate caps, change intervals, permissible indexes, and the like.

D. Consumers in home equity transactions may realize further substantive protections under state law. The exact content of state law will vary from jurisdiction to jurisdiction, but the states frequently legislate or regulate concerning such matters as --

- Interest rate ceilings (usury laws);
- Caps on the frequency and amounts of rate and payment adjustments in variable rate transactions;
- The right to pay off prior balances, or to refinance a balloon payment, at the original rate;
- Limitations on a creditor's right to declare default, accelerate balances, confess judgments, or foreclose on collateral (cf. Uniform Commercial Code §1-208; Uniform Consumer Credit Code §§ 5.109, 5.110);
- Maximum repayment schedules and restrictions on negative amortization; and
- Mandatory lead times for changes in the terms of open-end credit plans (cf. Uniform Consumer Credit Code §3.205).

At the very least, any new federal initiatives should be crafted with due consideration of this substantial body of related state law protections.

In sum, we urge Congress to narrowly frame any new most focused of legislative initiatives lest it duplicate existing law, and unnecessarily complicate transaction paperwork, increase creditor compliance costs, and stifle marketplace developments.

IV. Summary Concerns

As the Subcommittee proceeds with its review of home equity credit, CBA must clearly object to certain restrictive approaches that have been publicly discussed and/or proposed in recent weeks including those contained in H.R. 3468.

A. We believe it inadvisable to legislate sweepingly in an area that is in such a state of flux and development as home equity lending. Today's speculation about problems does not always become tomorrow's reality. We have seen no evidence of creditor overreaching or consumer abuse. In fact, the impression is unavoidable that creditors are competing vigorously, imaginatively and responsibly, and that consumers are responding with enthusiasm and a good measure of prudence.

We ask Congress to exercise some caution before imposing new requirements on transactions that are saturated with disclosures and consumer protections under time-tested Truth-in-Lending rules. At the very least, Congress should give the Federal Reserve Board the maximum opportunity to address home equity lending at the regulatory level, a process already underway, before carving new legislative stone.

Congress should be especially hesitant to take action on the basis of an incomplete record that would have the perverse effect of limiting for consumers their access to the liquidity in their home equity. Burdensome regulation increases creditor costs, which must be recouped from customers. Stringent restrictions on contract terms are a disincentive for creditors to offer that product, at least on a readily affordable basis. Informed consumers vote with their feet -- they choose or reject financial services based on their perceptions of costs and benefits -- and they have shown a strong disposition to choose home equity credit. We question the wisdom of pre-mature and ill-advised "preventative" action that would curtail that choice.

B. Much publicity has been given to the notion of "rate rise surprise." The concerns expressed are in fact objections to variable rate credit in any form, not just in home equity transactions. Adjustable rate credit is now well established and accepted, by credit extenders and borrowers alike. Rate caps are now required by law to be incorporated into the contract, and both federal and state rules may restrict rate ceilings, rate adjustments, and payment-schedule changes. The Federal Reserve Board has published proposals for revamping disclosures in adjustable rate purchase money mortgages. The policing of adjustable rate credit is already occurring and needs no special legislation for home equity transactions. Artificial (and arbitrary) rate caps, mandatory time limits and intervals, prohibitions on rate floors -- these are ingredients of direct rate regulation, and ultimately of consumer credit allocation, subjects that Congress has properly avoided.

C. Closed-end, purchase money mortgage regulations of the various federal regulatory bodies have been cited by analogy to justify similar kinds of substantive restraints on HELCs. There is, however, a fundamental distinction between purchase money mortgage loans and HELCs that renders such analogies erroneous. Purchase money mortgage loan proceeds are necessarily larger and are advanced to the borrowers at closing while HELC's lie dormant for long periods and are seldom drawndown completely. A purchase money lender is therefore assured of at least some profit up to the point at which pricing or other restrictions kick-in. In contrast, the HELC lender will see neither the magnitude nor consistency of loan usage over the life of an HELC relationship. Theoretically, the HELC lender could never see a dime of interest profit. Worse, the HELC lender may see the greatest account usage only at the point in which pricing and related restraints begin to operate, i.e., when market conditions have made other loans more expensive or difficult to obtain.

To suggest then that purchase money mortgage loan limitations are appropriate for HELCs is to ignore the substantial differences in the purposes, uses and practices respecting these forms of credit. HELC requirements must be based soley on the realities of HELC lending.

D. Much has also been said of the potential for consumer abuse in home equity transactions that permit the creditor to terminate or "accelerate" at will, confronting the consumer with a frozen credit line, or a large balloon payment, or even foreclosure on the home. We simply do not believe that this is a problem of any substance. For one thing, we do not know how widely such clauses are used in home equity credit, and have seen no data on it. More importantly, some forms of acceleration or termination-at-will clauses have been standard provisions in credit transactions for many years; they are a necessary precaution against the debtor's nonpayment or other default. Without a provision permiting the creditor to call the entire debt due in the instance of default, the creditor would be forced to separately sue on each installment as it fell due. This would present impossible financial and administrative burdens for lenders, debtors and the courts alike. We would also note that there is a well-established body of state law to discourage precipitous or bad faith exercise of this essential legal tool.

Aside from legal restrictions, it is rarely in the creditor's own interest to misuse such a clause. If the consequence is that the consumer defaults on the balloon obligation, the creditor must either initiate foreclosure (an inherently unattractive prospect given the second mortgage status of the HELC creditor), or refinance the obligation itself. The refinancing is generally subject to the same controls, as to rate and other terms, as the original transaction. Abusive exercise of a termination clause is, above all, poor public relations for any financial institution.

We do not suggest that additional limitations in this area, if grounded in commercial reason, cannot be effected. But we would again remind the Subcommittee that the Federal Reserve Board has recently solicited comments on the operation and effect of termination clauses, and is preparing to propose disclosure rules on them. This suggests first that Congress need not rush to fill a consumer protection void, and second that any remedial measures found needed may be capable of accomplishment by Board regulation without new legislation.

E. Suggestions that federal law should set maximum loan-to-value ratios for home equity credit would so deeply intrude the Congress into the substantive terms of consumer transactions as to deprive consumers of access to a portion of their home equity. A consumer needing or wanting to liquidate that equity could sell it, but could not borrow against it! In addition, the creditor is most likely to exercise self-discipline in setting a realistic loan-to-value ratio in order to protect it's investment. The CBA survey clearly reflects that conservatism prevails in this respect.

F. Finally, we must express certain concerns as to the proposed expansion of Truth-in-Lending law beyond the bounds of its original purposes and congressional intent. Many of the initiatives under discussion today propose substantive limitations on the nature of the debtor-creditor relationship. These include pricing restraints, mandatory time limits and intervals, secondary market protections and other restrictions that differ in kind from the disclosure objectives of TILA.

Our point is more than a legal purist's objections to this less than subtle alteration of TILA. Our concern is that a federal statute framed with due regard for the sovereign authority of the states to substantively regulate consumer contract law may now become a vehicle for trampling that authority. We are troubled by the substantial expansion in scope of a statute which has in the past been construed in a very strict and hypertechnical fashion. We are concerned lest a law, whose substantial punitive penalties were justified by its narrow focus on relatively simple matters of form, is to be converted into a sanction for far less easily defined matters of conduct.

In short, CBA views the expansive thrust of many of the initiatives under consideration today with some degree of alarm. These initiatives would substantially alter a complex but fairly well-understood body of law designed for other purposes. They would go a long way towards establishing a federal contract law, a result Congress has assiduously avoided to date. To the extent that this becomes the ultimate congressional objective, CBA respectfully submits that it should be effected as a stand-alone proposition, with its own set of well-considered remedial measures and its own separate and clearly defined legislative history. The complex but fairly well-settled body of Truth-in-Lending law and regulation should not be bent to serve these new and unintended purposes.

V. Conclusion

The Consumer Bankers Association is proud of it's record of supporting well-drafted legislation to improve the flow of information to consumers and to prohibit truly abusive and anti-competitive practices. We share some of Congress' concerns about the rapid growth of home equity credit, and have taken the lead in our industry to study that growth, and to educate our members and the public about possible problems.

We believe the evolving picture of home equity credit needs watching, and that those transactions may need further regulatory refinements. A process toward those ends is underway at the Federal Reserve Board, and we suggest the Subcommittee closely monitor that activity. If the record of these hearings justifies it, we would support some sharply focused statutory disclosure rules for home equity transactions, similar to those proposed by H.R. 3011 and as modified by the recommendations outlined in the Appendix to this testimony.

Mr. Chairman, members of the Subcommittee, I want to again thank you for the opportunity to appear today on behalf of CBA. I would be pleased to respond to any quesions you may have.

Senator DODD. Thank you very much.

Mr. Harman.

STATEMENT OF THOMAS D. HARMAN, VICE PRESIDENT AND GENERAL COUNSEL, MERRILL LYNCH EQUITY MANAGEMENT, INC.

Mr. HARMAN. Mr. Chairman, I am Thomas D. Harman, vice president and general counsel of Merrill Lynch Equity Management, Inc., in Stamford, CT. It is a pleasure to provide you with Merrill Lynch Equity's thoughts on home equity lines of credit.

Merrill Lynch Equity is a subsidiary of Merrill Lynch & Co., Inc. It began offering home equity lines of credit in California in the summer of 1982. Since then, Merrill Lynch Equity has grown into one of the largest issuers of home equity credit lines, nationwide. Merrill Lynch Equity currently offers home equity credit lines to consumers in 39 States and the District of Columbia.

In the period of over 5 years during which Merrill Lynch Equity has been offering home equity credit lines, Merrill Lynch Equity has observed few consumer problems, in connection with this product. The product has been very well received by consumers.

To date, Merrill Lynch Equity has received over $3.3 billion in applications for equity credit lines, and has extended over $1.6 billion in credit lines. Merrill Lynch Equity has avoided marketing gimmicks such as "teaser" rates. We qualify applicants for credit by determining whether their income will support their monthly payments, even at significantly higher interest rates. As a result of these factors and Merrill Lynch Equity's stringent underwriting guidelines, our foreclosure experience has been very favorable. To date, approximately one in a thousand of the credit lines which we have established has been terminated by foreclosure, and foreclosure is pending on only an additional one in a thousand of the credit lines.

Merrill Lynch Equity brings this product to the public's attention through limited advertising and direct mail programs. In addition, Merrill Lynch financial consultants counsel those of their clients who might be suitable candidates for, and benefit from, home equity credit lines. The financial consultants advise Merrill Lynch Equity of clients who desire to apply for equity credit lines.

Credit decisions are based both upon the applicant's verified income, resources and credit history, and upon the appraised value of the applicant's house and the outstanding balance of any first mortgage.

TWO AREAS THAT RAISE QUESTIONS

Two areas of equity credit line lending which have raised questions in the past are the lender's right to change the terms of an equity credit line after it has been established, and the lender's right to cancel an equity credit line and to require that it be paid in full, prior to its stated maturity.

As Congressman Price mentioned in his testimony, the loan documents used by Merrill Lynch Equity throughout the country require that, if Merrill Lynch Equity desires to change the credit line terms after the credit line has been established, Merrill Lynch Equity must give the borrower advance notice of any proposed change. If the borrower does not wish to accept the proposed change, the borrower can draw down as much of the credit line as he or she desires within a specified time frame, and then notify Merrill Lynch, in writing and within the specified time frame, that the borrower does not wish to accept the change. A borrower who does not wish to accept a change in terms may not draw down any more funds on the credit line after the borrower rejects the change, but the funds outstanding will continue to be governed by the original terms.

Merrill Lynch Equity's credit documents provide that the term of the credit line is 10 years. The documents do not give Merrill Lynch Equity the right to terminate the credit line before the expiration of the 10-year period, unless the borrower defaults on his or her obligations under the documents, or unless laws which become effective after the date that the equity credit line is established significantly impair the operation of Merrill Lynch Equity's equity credit line program. An example which comes to mind of a law which might have this effect is a State law which reduced the usury limitation below the lower of Merrill Lynch Equity's interest rate cap or the usury limitation which was in effect when the credit line was established.

Accordingly, Merrill Lynch Equity could not terminate its equity credit line solely because a consumer financial situation deteriorated or the customer became unemployed. It is true that if a consumer defaults on a home equity credit line, the lender may begin foreclosure proceedings, which could lead to the loss of the consumer's house. In analyzing this potential scenario, it is important to bear in mind that the same result could occur if a borrower who was a homeowner defaults on a substantial "unsecured" loan or line of credit. This is because the lender would probably obtain a judgment against the borrower, file a judgment lien against the borrower's house, and execute on the judgment lien. Responsible lenders follow work-out and credit counseling procedures to avoid foreclosure.

Merrill Lynch Equity supports full and fair disclosure to borrowers and potential borrowers in connection with all consumer credit transactions. Such disclosure enables the potential borrower to compare the various types of credit available, and to be informed of the basic terms of the available credit before being irrevocably obligated on the relevant credit instruments.

In general, Merrill Lynch Equity supports H.R. 3011 because it furthers the purpose of making full and fair disclosure to consumers regarding home equity credit lines, prior to the time that the consumers become obligated on a home equity credit line.

However, the disclosures required by this legislation, when combined with the disclosures already required, might result in such extensive disclosure, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures.

The chances of this adverse result to consumers occurring would be less if this legislation was revised so as to provide that the required disclosures were to be given in place of the disclosures required by other Federal or State laws and regulations.

Merrill Lynch Equity supports the goals which H.R. 3468 is intended to achieve, and the disclosure provisions of this bill. However, Merrill Lynch Equity is concerned about the requirements regarding the terms upon which lenders may offer equity credit lines. These requirements could result in all borrowers paying significantly more for home equity credit lines, and could prevent borrowers from obtaining home equity credit lines on terms which might be appropriate for particular borrowers' circumstances.

Merrill Lynch Equity feels that the free market and the demand of borrowers for various products should determine what features lenders offer in equity credit line loans. This same free market, driven by consumer demand, has resulted in the availability of a variety of types of conventional variable rate mortgage loans which are attractive to both borrowers and lenders.

Mr. Chairman, I would like to thank you for the opportunity to appear before your subcommittee today, and I would be happy to answer any questions which you might have.

[The complete prepared statement of Thomas D. Harman follows:]

6 Tips for Wise Use

By following these six guidelines, you can make wise use of your home equity line of credit:

1. Home equity credit is best used for *major expenditures* such as home improvements, children's college expenses, or major medical or emergency expenses. It can also be used to consolidate other debts at a lower interest rate. Because the equity in your home represents a substantial source of savings, it should not be used to finance current consumption such as food, clothing and entertainment.

2. Don't borrow more than you can afford to *repay over a reasonable period* of time. For instance, if you use your line of credit to pay for a car, pay it off as soon as you would pay off a regular car loan, usually over a period of three to five years.

3. *Interest only* payments are offered by some lenders, and may be appropriate when special circumstances may make it difficult or undesirable to pay down the principal, such as when children are in college. Generally, it's preferable to pay down principal to retire your debt.

With some plans, interest-only payments lead to a *balloon*, when the unpaid balance is due. This may be appropriate only for those who can predict that they can pay off their loan—perhaps because they plan to sell their home—or who are willing to refinance at the rate prevailing in the future. Be sure your income will be sufficient to qualify you for refinancing.

4. Total monthly payments on all types of loans should not exceed about *35 percent of your monthly before-tax income*. A good banker will help you determine how much debt you can afford.

5. Most home equity loans have a *variable interest rate*, meaning payments could fluctuate. Make sure you understand the terms and can afford the increase in the rate of interest if it should occur.

6. Interest payments on home equity loans *may* be fully tax deductible. *Consult a qualified tax specialist*, as each homeowner's situation is different.

Questions to ask your loan officer:

- Is a home equity line of credit most suitable for my needs, or would another kind of loan be more appropriate?
- What is the initial rate of interest? Is it fixed or variable? If it is variable, on what index is it based? How often can the rate change? Is there a cap or maximum increase in interest rate?
- What fees must I pay at the time of application and closing? Is there an annual fee?
- What will my minimum monthly payment be for each $10,000 in credit, and how much of the minimum payment will go to principal?
- If interest rates go up, will my minimum monthly payment go up with a variable rate loan? What increase in rate would cause my payment to go up?
- Are there circumstances under which my outstanding debt can increase if I only make the minimum payment?
- Are there conditions under which I can reduce my monthly payment? Will I still be paying down principal?
- Under what conditions can the bank demand repayment or refinancing of my outstanding credit? Can any of the credit terms be changed without my approval?
- Do I have an option of converting my line of credit into a fixed term installment loan to pay it off? If so, at what interest rate, and over what period of time?
- If my income or amount of available equity increases in the future, can I have my line of credit increased? Will I have to pay new fees? Will I have to requalify?

CBA
CONSUMER BANKERS ASSOCIATION
1300 N. 17th Street, Suite 1200, Arlington, VA 22209

APPENDIX A

What You Should Know

About a Home Equity Line of Credi

CBA
CONSUMER BANKERS ASSOCIATION

CURRENT HOME EQUITY [illegible]
DISCLOSURES REQUIRED BY
TRUTH-IN-LENDING ACT ("Act")/REGULATION Z ("Reg Z")*

Advertising (Act §143; Reg Z §226.16)

- Must be accurate
- Must reflect terms actually offered
- Use of "trigger" term requires additional disclosures

  e.g. trigger terms:

  - 17 % A.P.R.
  - Small monthly service charge on remaining balance.
  - $20 Annual membership fee buys you $2,000 in credit.
  - No finance charge if you pay your full balance each month.

  "Required" additional disclosures:

  - Any minimum, fixed, transaction, activity or similar charge that could be imposed
  - A.P.R. and variable rate, if applicable
  - Membership or participation fee

Initial Statement (Act §127; Reg Z §226.6)

(Written disclosures made to consumer before account can be opened)

- Finance charge: explanation of charges, methods of computation, free ride periods, periodic and annual rates and when they apply
- All other charges that may be imposed
- Security interest description
- Statement of federal billing and error resolution rights
- 2 right of rescission** notices because credit plan is secured by consumer's dwelling (see Act §125; Reg Z §226.15)

Periodic Statements (Act §127; Reg Z §226.7)

- Previous balance
- Identification of each transaction during the period
- Credits to the accounts
- Periodic and annual rates
- Balance to which finance charge is applied and how it is computed
- Amount and components of finance charge
- Actual A.P.R. for the period
- Other charges itemized and identified
- Closing date of billing cycle
- New balance on that date
- Free ride period
- Address for notice of billing errors

Subsequent Disclosure Requirements (Act §122; Reg Z §226.9)

- Statement of federal billing rights, at least annually
- New credit devices/features added to plan must be disclosed prior to usage by consumer
- A change in terms must be disclosed at least 15 days prior to effective date of change
- Right of rescission and notices, whenever credit limit is increased (see Act §125; Reg §226.15)
- Billing error resolution notices to consumers and others (see Act 170; Reg Z §§226.13(c), -(e) and -(g))

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* Act - 15 U.S.C §1601 et seq.
Reg Z - 12 CFR Part 226

** Consumer has 3 day right to cancel opening of account, i.e., 3 day "cooling off" period to review all terms of account agreement

APPENDIX C

Recommended Refinements to H.R. 3011

A. Limitation of the Application Disclosure Scheme to HELC's Secured by the Consumers "Principal" Dwelling. All other special protections accorded by the Truth in Lending Act to dwelling-secured credit transactions are limited to the consumer's principal residence or true household.[*] This also seems to be the focus of congressional concern here (rather than vacation or investment property). H.R. 3011 should reflect that focus by limiting its coverage to plans secured by a "principal" dwelling.

B. Inclusion of All "Generic" Information in the Federal Reserve Pamphlet. Section 3 of H.R. 3011 calls for the Federal Reserve Board to develop a consumer pamphlet describing general HELC lending practices and the potential advantages and disadvantages of HELC plans. Creditors are to distribute these pamphlets to consumers at the time of application.[**] We submit that some of the application stage disclosures called for under section 2(a) of the Price bill could be included in these pamphlets, thereby simplifying the application stage disclosure scheme. For example, interest only payment and change-in-terms features could be more briefly acknowledged in the segregated disclosure statement, where applicable, and discussed in the indicated detail in the pamphlet.

C. Limitation of "Conspicuously Segregated" Disclosure Requirement to Application Stage Disclosures. Section 2(a) of H.R. 3011 calls for the "conspicuous segregation" of the new HELC disclosures from other information provided in connection with the HELC plan. Since these new disclosures may also be required in connection with the initial Truth-in-Lending disclosure statement, there should be a clarifying limitation to the effect that this segregation requirement applies solely to the application stage. This would greatly reduce compliance burdens by eliminating the need for massive revisions to now standardized initial disclosure statements. Such a limitation would in no way undercut the bill's early disclosure objectives.

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[*] E.g., right of rescission, 15 USC §1635

[**] As presently framed, section 2(a) of H.R. 3011 could require such distribution at both the application and account-opening stages, a needless redundancy. The latter distribution requirement should be deleted.

D. Modification of APR Disclosure Requirement. Section 2(a) of H.R. 3011 calls for disclosure of the APR ". . . which will be in effect when credit is first extended . . ." Since many of these plans lie "dormant" for long periods after they are opened, this reference point is unknowable and the disclosure requirement should be modified accordingly. Disclosure of a nominal interest rate applicable at or near the time the HELC was opened might suffice.

E. Provision of Disclosures Should be Triggered by Receipt of a "Written" (or otherwise "Completed") Application; Sending of Disclosures Within Three Business Days Following Phone or Mail Applications Should Suffice. The full panoply of Truth in Lending civil sanctions would apply to a failure to comply with H.R. 3011's application stage requirements. Failure to provide these disclosures to persons making purely casual inquiries or failure to insure that disclosures are actually received by telephone or mail customers within 3 business days should not carry such severe penalties.*

F. The Advertising Requirements in Section 2(c) of H.R. 3011 Largely Duplicate Section 143 of the Truth in Lending Act and Should be Eliminated or Substantially Reduced. Proposed new TILA section 147(a) largely restates existing TILA section 143 and is, therefore, redundant. We note also that existing sections 105 and 143 give the Federal Reserve Board broad authority to require additional open-end disclosures. Since the Board staff is already in the process of promulgating such recommendations, we urge Congress to consider those initiatives before acting in this area. Finally, the prohibition of references to "prime" in HELC account offerings seems excessive -- many HELC plans are literally indexed to prime rates and TILA disclosure would be difficult if not impossible without a reference to prime. Further, some HELC plans may carry proprietary labels using the word "prime". Board authority to restrict trade or service mark usage of this sort is unclear at best.

G. Uniform Federal Disclosure Rules Are Important. The disclosures required by H.R. 3011 should establish uniform credit shopping standards, and should be comparable wherever the creditor or consumer is located. To ensure this objective, CBA recommends the inclusion of language clearly preempting the states from enacting different or additional

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* Some consideration might be given to moving the Fed Pamphlet requirement into Truth in Lending's advertising rules (§ 143) if the goal is to provide earlier credit shopping information. The advertising rules do not incorporate Truth in Lending civil sanctions. Creditors would be more inclined to disseminate information freely in the absence of the threat of civil liability.

disclosure requirements in connection with HELC applications. This approach has been adopted already in this session by the House Banking Committee with respect to credit card application disclosures (H.R. 515). To our knowledge, no existing state laws have addressed application stage HELC disclosures, thus Congress would be acting only to keep the slate clean of potentially conflicting requirements and would not be intruding in an area of existing state law.

H. Additional Compliance Lead Time Is Necessary. H.R. 3011 provides only six months for regulatory implementation of extensive Truth-in-Lending amendments. Truth-in-Lending changes are currently effected on an annual basis providing for six months between the completion of final rulemaking and required compliance. We therefore suggest an extension of H.R. 3011's effective date to at least nine months after the date of enactment.

Statement of
Merrill Lynch Equity Management, Inc.
On Home Equity Lines of Credit
Presented by
Thomas D. Harman
Vice President and General Counsel
Before the
Subcommittee on Consumer Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate

November 18, 1987

Mr. Chairman and members of the Subcommittee, I am Thomas D. Harman, Vice President and General Counsel of Merrill Lynch Equity Management, Inc., in Stamford, Connecticut. It is a pleasure to provide you with Merrill Lynch Equity's thoughts on home equity lines of credit.

Merrill Lynch Equity is a subsidiary of Merrill Lynch & Co., Inc. It began offering home equity lines of credit in California in the summer of 1982. Since then, Merrill Lynch Equity has grown into one of the largest issuers of home equity credit lines, nationwide. Merrill Lynch Equity currently offers home equity credit lines to consumers in 39 states and the District of Columbia.

You have asked us to comment on problems the consumer faces in dealing with home equity credit lines, how Merrill Lynch Equity handles equity credit lines, and what legislation, if any, Merrill Lynch Equity feels should be enacted. You also asked us for our reaction to Congressman Price's bill, H.R. 3011, and to Congressman Schumer's bill, H.R. 3468.

Problems faced by Consumers in Dealing with Home Equity Credit Lines

In the period of over five years during which Merrill Lynch Equity has been offering equity credit lines, Merrill Lynch Equity has observed few consumer problems, in connection with this product. The product has been very well received by consumers.

To date, Merrill Lynch Equity has received over $3.28 billion in applications for equity credit lines, and has extended over $1.6 billion in credit lines. Merrill Lynch Equity has avoided marketing gimmicks such as "teaser" rates (low initial interest rates which revert to a higher rate after a brief time period). We qualify applicants for credit by determining whether their income will support their monthly payments, even at significantly higher interest rates. As a result of these factors and Merrill Lynch Equity's stringent underwriting guidelines, our foreclosure experience has been very favorable. To date, only about one in a thousand of the credit lines which we have established has been terminated by foreclosure, and foreclosure is pending on only an additional one in a thousand of the credit lines.

Merrill Lynch Equity feels that it is very important that consumers be aware of both the advantages and disadvantages of obtaining home equity credit lines, so that a consumer can make an informed decision as to whether a home equity credit line is appropriate for the particular consumer, and, if so, which of the many types of home equity credit lines offered is most appropriate for the particular consumer's needs.

Although lenders have offered loans secured by borrowers' houses for many years, home equity credit lines offer a number of advantages to the consumer, over more traditional sources of credit. The major advantages of home equity credit lines for the consumer include the following:

1. Home equity credit lines offer the borrower a great deal of flexibility in credit management. They allow the borrower to closely manage his or her credit by borrowing (and paying interest on) only the exact amount that he needs at any time. For example, if a borrower were to use a conventional second mortgage loan to finance a college education or construct an addition on his or her home, the borrower would need to draw down (and pay interest on) the entire loan amount when the borrower established the loan, even though the bills for the education or the home improvement would be presented over a period of months or years. Furthermore, with a home equity credit line, a borrower can pay additional principal in months when the borrower has more income, thus reducing the principal balance on which the borrower has to pay interest, and pay only the minimum amount due during months when the borrower has less income. In addition, an equity credit line borrower who has repaid some of the principal balance will still have access to additional credit.

2. Home equity credit lines provide the consumer with a very convenient source of credit which allows the consumer to keep his or her personal business personal. Once the consumer's application has been approved and the consumer has established a line of credit, the consumer may draw down as much credit as he or she desires up to the consumer's credit limit, without filing a new application and revealing further personal and financial information to the lender, prior to each need for credit. Access to credit is as convenient for the borrower as writing a check.

3. Home equity credit lines offer qualified borrowers access to substantial amounts of credit, for personal and business needs.

4. Because home equity credit lines are secured loans, lenders can often charge less interest on these loans than on other types of loans (such as credit cards and unsecured personal loans).

The potential disadvantages of home equity credit lines include the following:

1. Consumers for whom home equity credit lines might not be the most appropriate source of credit may obtain home equity credit lines. Merrill Lynch Equity feels that the best way to alleviate this potential problem is to assist in efforts to educate consumers as to the advantages and disadvantages of various sources of credit. Fortunately, a great deal has been written in the popular press recently, regarding the advantages and

Senator DODD. Thank you very much. I thank all three of you. I'm not going to keep you long because there's another vote on, but I understand I have about 20 minutes to get there, so I'm going to ask some things that I was going to sit here and go over with you in detail, but I think what I will do with a couple of these things is to ask you to maybe submit some things.

One is to the ABA. Let me commend the ABA for your kit you're putting together. I think that's creative. It's getting ahead of the curve. I think it's helpful and it might be worthwhile if you could just submit to the committee some of the details of it, how you arrived at certain things and so forth. It might be helpful for us to get that.

I was going to probe that with you a little bit, but I think it might be wise to use the time getting to some of the other general questions.

Peter Kinzler is my staff director. I think most of you at the table know him and, poor Peter, I'm going to expose him here a little bit. Other people cite unnamed people going out trying to do things. I've discovered that my staff director has tried to get a home equity loan and has gone out and apparently went through an elaborate process, spending countless hours going over and reviewing various options in the Greater Washington Area and finally settled on one particular institution, only to find out after he had gone over and spent about 25 hours of research, getting information, soliciting more and so forth, that the one particular place he chose held out the right for the unilateral changing of the contract which I've discussed earlier.

Nonetheless, you see there someone who is spending a lot of time and really soliciting a lot of information and with all of that still finds in the final analysis they haven't picked up everything.

Second, I'd like you to look at—I'm going to send this down to you to look at because this is just dazzling. We've spent time looking at this thing, but you've got to see this.

CONFUSING MONTHLY STATEMENT

This is a copy of a monthly statement for a home equity loan. Let me give it to you and then follow it with me, and maybe you can quickly explain this thing to me. But follow along with me, if you will.

At the very bottom it states the basis for determining the finance charge and the daily periodic rate times the average daily balance. In this case, the amount is $92.92. You see that finance charge to the right is the column going across second from the bottom right in the center, $92.92. Above that, it states the date of the last payment and says that $73.35 was "applied to finance charge." $73.35 is at the very top. Then it says below that of the $92.92 finance charge, $36.54 was for "payments during cycle applied to this cycle's finance charge." It then says $56.38 was a "finance charge due included and minimum payment due."

Now I stared at that sucker for a long time and I can't figure that one out for the life of me. This is what people get back. And if you're talking about an average person trying to figure out these things, isn't that confusing? Isn't there some way that thing could be stated in much more clear, concise terms so that you could look at it and maybe understand where the finance charges were coming from?

Mr. **Harman**. Mr. Chairman, I think this is confusing and I think that it's a perfect example of how we have to proceed carefully.

Senator **Dodd**. I didn't make this up either. This is a real one.

Mr. **Harman**. I think it's a perfect example of how we have to proceed carefully with regulation because sometimes well-intentioned regulation which is intended to inform the consumer results in disclosure that the consumer can't understand. So, of course, the consumer's initial reaction is to just overlook the whole thing and just try to figure out how much he's supposed to pay. I think this is something that gives rise to great care on the part of legislators.

Senator **Dodd**. Well, I'm not sure this is the result of regulation.

Mr. **Ferguson**. Mr. Chairman, I don't want to be out on a limb with First American at this point, but it appears that it could be a typo in the sense that that $56.38 really should be $156.38 as up at the right-hand corner at the top, which would be the minimum payment due, and included in that was the finance charge.

Senator **Dodd**. If you add all those together, you might get that.

Mr. **Harman**. Of course, regulation Z has extensive provisions regarding what information must be included on a periodic statement and I can't tell by looking at this——

Senator **Dodd**. I won't belabor it. I just wanted to highlight a point I'm making because those kind of issues do raise problems. I understand and I agree with you. I think sometimes you get instructions for people or consumer protections and I can't read them any longer. I'm nearsighted, not farsighted, but I sit there and try and follow what we've obviously designed to protect the consumer and in many cases I think we overwhelm them to such a degree that you lose all interest. I think it's a very legitimate point, but these things ought to be done. And you may be right, but nonetheless, even if you get that, arriving at that thing is a rather confusing document to read if you're even a knowledgeable consumer and an interested consumer. That was really my point to you, if I could.

Let me raise a couple of questions to you as well. I'll try and do this fast.

You indicate, Mr. Ferguson, that the consumer can use the right of rescission to cancel a home equity loan at no cost. You don't suggest by that as well that the closing costs and other things would be reimbursed, or whatever percentage you might work out would come back. That's a pretty hefty cost for a lot of people.

Mr. **Ferguson**. Well, that's true. But I think in many cases you will find that certainly in the environment we are in now that in most of these there are no closing costs. I think it's a no-cost deal in a lot of instances.

Senator **Dodd**. Some of them are, the ones that highlight those, but I think it would be wrong to suggest that there is not a cost associated with just rescission.

You all sort of pointed out to one degree or another that there doesn't seem to be much of a problem here yet with the home equity loan and foreclosures.

The first obvious question that comes to me is that we've seen only recently this tremendous surge of activity. And since most of these loans we're talking about run for a 10- to 15-year period, isn't it correct to assume that we really don't know the answer to that yet? I'm not suggesting you're wrong, but it's far too early to suggest that we have any indication of how well consumers are going to be able to meet their financial obligations under these loans.

Do any of you disagree with that?

Mr. HARMAN. Well, Merrill Lynch has been in the business for 5 years. The rate or growth for our equity credit lines was no greater this year than it was before tax reform.

Senator DODD. I'm sorry?

Mr. HARMAN. Merrill Lynch has been in the business 5 years and our growth rate did not increase significantly this year over previous years.

Senator DODD. What is the term of the loans on the average, 10 to 15 years?

Mr. HARMAN. Ten years.

Senator DODD. So you've been there for 5.

Mr. HARMAN. And we've had loans outstanding for 5 years and have been fortunate, as I say, in having a very favorable foreclosure experience over this period.

Mr. Chairman, may I add, in response to a previous question, that regulation Z does require the lender to refund to the consumer all costs that the consumer has incurred if the consumer elects to rescind the transaction.

Senator DODD. At what point?

Mr. HARMAN. Excuse me?

Senator DODD. At what point, the rescission?

Mr. HARMAN. If the consumer rescinds within 3 days after signing the credit documents.

Senator DODD. Well, we're not talking about 3 days here. You can change the rules in 15 days. Fifteen days after you've established rules you can change them.

Mr. HARMAN. I'm sorry. I thought your question was——

Senator DODD. I know, but my point is, 15 days after you establish what the rules will be you are permitted to unilaterally change them.

Mr. HARMAN. Right, as to future advances.

Senator DODD. So that consumer on the 15th or 16th day doesn't get back the closing costs.

Mr. HARMAN. Right, although under our program he has the right to continue with the old terms on his existing balance.

Senator DODD. Obviously, different places do different things with this.

Mr. KIRKPATRICK. Mr. Chairman, to add weight to what Mr. Harman said, we've been in existence since 1982 also, not quite the number and volume since we operate only in one State, but our experience has been basically the same. We've always marketed the product as an economical, prudent means of borrowing for the consumer which the ABA has supported, and I think the numbers on usage and lower balances in relation to committed lines proves that consumers are using these prudently and wisely and not in a frivolous way.

Senator **Dodd**. Well, as you all point out, you're dealing with a middle-income or upper-middle-income and beyond category that's going for these. So there's an education level and so forth. There may be some concern about whether or not you will just stick with that kind of a profile or whether or not it will expand and get down into an income category where there's going to be a closer call. That's all I'm suggesting.

I presume most banks—you don't want to own homes.

Mr. **Kirkpatrick**. Obviously, that's correct.

Senator **Dodd**. A lot of States allow you to. As you point out in your testimony, Mr. Harman, on normal consumer loans, unsecured loans, you run the risk of jeopardizing your home. That's true. There are an awful lot of States that make that awful difficult for a bank to get their hands on a home. They will let you grab everything else, but the home has been something that, by State statute and regulation, has been held pretty far away from the mitts of a lender as a general matter.

They're screaming at me here about votes, but there are so many questions I have.

The prime rate—you heard the Fed say the use of the board of directors situation will decide what that is. Do any of you have any difficulty with using the public indices?

Mr. **Ferguson**. No, we use that currently now.

Senator **Dodd**. I assume most of you do. Isn't that a better way to proceed generally?

Mr. **Kirkpatrick**. The ABA supports using an internally generated prime. We've got no problem with that. But we go with a broader, sometimes six or seven composite menu, we would have to see what it is.

Senator **Dodd**. I don't have any problem with that, just so they're public indices we generally can go on.

Would you quickly respond to the unilateral question, the one that raised the other issue about changing the rules? You heard Alan Fox talk from the Consumer Federation, the Fed, and two Congressmen speak, and you understand the problem people see with that and people up here on this panel see. The consumer is going out and incurring a pretty hefty financial obligation and I'm not suggesting people are going to go and dramatically, 180 degrees, change the rules just to take the consumer to the cleaners. You've got your problems as well when things occur that you don't control and you've got to take that into consideration as you look over what your obligations are to your investors and other people that you've got an obligation to.

But what can be done in that area so that you minimize what seems to be a very significant imbalance?

Mr. **Ferguson**. Mr. Chairman, I think that anything that's arbitrary and capricious in the contract just shouldn't be there. That's our position on that and I think there's a fair amount of body of State law that makes you provide notice on something that would come up relative to term changes and give an opportunity for a person to get out of a particular loan situation into another one.

To carry that a little bit further, as both these gentlemen said and I think you have somewhat supported, obviously we're not in a position to be in the real estate business. We certainly want to be in a lending business, and foreclosures are not very attractive for anyone. So that kind of situation, if in fact we were put in that, if somebody wants out, we would dearly like to fix that loan. If we've got a matched funding scenario, it shouldn't be a problem for a lending institution.

Senator DODD. I'm going to ask you if you would give some consideration to something, whether it was report language or other things we might want to put in, that would be talking about—there are certain things that I would presume everybody would agree just shouldn't be allowed to be changed. There are other things that obviously you have to leave open and subject to some change based on what happens. Ten or 15 years in the kind of world we're living in today is a fairly risky environment.

But you might give us some suggestions on things that ought not to be subject to change without consent and so forth of the consumer in a contractual relationship like this. I'd be very interested if you had any thoughts on areas like that.

Mr. HARMAN. We did change our terms this past spring, when we reduced the interest rate in response to competitive pressures.

The other circumstance in which I could imagine a change in terms would be if our index, which is the prime rate, 5 or 10 years from now deviated significantly from our cost of funds. We might then feel that it was necessary to change the index from the prime rate to something else. Of course, for some borrowers they might pay less but other borrowers might pay more. That's the kind of flexibility that we would need.

Senator DODD. I apologize again and thank you for being so patient and staying. We will submit some additional questions but I'm being bugged by the cloakroom and I don't want to have you wait another 20 minutes until I come back. I think we can submit some questions to you and it will be a little easier on all of you.

Thank you for being here and I do commend the ABA for your package.

Mr. KIRKPATRICK. Thank you for your input.

Senator DODD. The subcommittee will stand adjourned until further call of the chair.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]

[Additional material received for the record follows:]

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disadvantages for consumers of home equity lines of credit. Furthermore, responsible lenders using prudent underwriting guidelines will not extend credit to applicants whose resources and credit history do not suggest an ability to satisfy credit obligations.

2. If a consumer defaults on a home equity credit line, the lender may begin foreclosure proceedings, which could lead to the loss of the consumer's house. In analyzing this potential scenario, it is important to bear in mind that the same result could occur if a borrower who is a homeowner defaults on a substantial "unsecured" loan or line of credit. This is because the lender would probably obtain a judgement against the borrower, file a judgement lien against the borrower's house, and execute on the judgement lien. Responsible lenders follow work out and credit counselling procedures, to avoid foreclosure. Finally, a number of the advantages of home equity credit lines identified above are a direct result of the fact that they are secured by the borrower's house.

How Merrill Lynch Equity Handles Home Equity Credit Lines

Merrill Lynch Equity offers its home equity credit lines on substantially the same terms to consumers in all forty jurisdictions in which it makes this product available. However, state law sometimes requires some variation in product terms. Merrill Lynch Equity brings this product to the public's attention through limited advertising and direct mail programs. In addition, Merrill Lynch Financial Consultants counsel those of their clients who might be suitable candidates for, and benefit from, home equity credit lines. The Financial Consultants advise Merrill Lynch Equity of clients who desire to apply for equity credit lines.

All of Merrill Lynch Equity's facilities and staff are located at two sites in Connecticut. Merrill Lynch Equity sends prospects who may be interested in equity credit lines information and applications, from these Connecticut sites. At these sites, Merrill Lynch Equity receives and processes completed applications, arranges for property appraisals and title searches, obtains credit reports and decides which applicants to approve for equity credit lines, and what amount is to be approved. Credit decisions are based both upon the applicant's verified income, resources and credit history, and upon the appraised value of the applicant's house and outstanding balance of any first mortgage.

Merrill Lynch Equity arranges for closings at the office of an attorney or title insurance company convenient for the borrower. After the closing, Merrill Lynch Equity services the equity credit lines. The servicing includes arranging for equity credit line checks to be honored when utilized by the borrower, and having monthly statements prepared and mailed.

Two areas of equity credit line lending which have raised questions in the past are the lender's right to change the terms of an equity credit line after it has been established, and the lender's right to cancel an equity credit line and to require that it be paid in full, prior to its stated maturity.

The loan documents used by Merrill Lynch Equity throughout the country require that, if Merrill Lynch Equity desires to change the credit line terms after the credit line has been established, Merrill Lynch Equity must give the borrower advance notice of any proposed change. If the borrower does not wish to accept the proposed change, the borrower can draw down as much of the credit line as he or she desires within a specified time frame, and then notify Merrill Lynch, in writing and within the specified time frame, that the borrower does not wish to accept the change. A borrower who does not wish to accept a change in terms may not draw down any more funds on the credit line after the borrower rejects the change, but the funds outstanding will continue to be governed by the original terms.

From a lender's point of view, it is important that the borrower be required to notify the lender within a specified time period if the borrower desires to reject the new terms. Otherwise, when the time came to implement the new terms, the lender would not know which credit lines to freeze and to continue to bill on the basis of the original terms, and which credit lines to begin billing on the basis of the new terms.

Merrill Lynch Equity's credit documents provide that the term of the credit line is ten years. The documents do not give Merrill Lynch Equity the right to terminate the credit line before the expiration of the ten year period, unless the borrower defaults on his or her obligations under the documents, or unless laws, regulations or agency or court interpretations which become effective (in whole or in part) after the date that the equity credit line is established significantly impair the operation of Merrill Lynch Equity's equity credit line program. An example which comes to mind of a law which might have this effect is a state law which reduced the usury limitation below the lower of Merrill Lynch Equity's interest rate cap or the usury limitation which was in effect when the credit line was established. Another example is a state or federal law or regulation which impaired Merrill Lynch Equity's ability to vary the interest rate, on the terms set forth in Merrill Lynch Equity's credit documents.

Accordingly, Merrill Lynch Equity could not terminate its equity credit line solely because a customer's financial situation deteriorated or the customer became unemployed.

Need for New Legislation

As indicated above, Merrill Lynch Equity supports full and fair disclosure to borrowers and potential borrowers in connection with all consumer credit transactions. Such disclosure enables the potential borrower to compare the various types of credit available, and to be informed of the basic terms of the available credit, before being irrevocably obligated on the relevant credit instruments.

The Truth-in-Lending Act and Regulation Z already require lenders to make extensive disclosures in connection with home equity credit lines. Specifically, Section 226.16 of Regulation Z requires lenders to make comprehensive disclosure of the terms of home equity credit lines, in connection with advertisements that state certain specified terms of the credit being offered; Section 226.6 requires extensive disclosures of the credit terms, before the first transaction is made under a home equity credit line; Section 226.7 requires further disclosures with each monthly billing statement; and Section 226.15 provides for a right of rescission. Other parts of Regulation Z regulate other aspects of home equity credit line transactions.

In addition, in those states where a lender is relying on the pre-emption of state law afforded by the Alternative Mortgage Transaction Parity Act of 1982 (Title VIII of the Garn-St. Germain Depository Institutions Act of 1982) in order to offer equity credit lines to borrowers, the lender must comply with the extensive additional disclosure requirements of the Comptroller of the Currency, the National Credit Union Administration Board or the Federal Home Loan Bank Board (depending upon the type of lender). Some types of lenders must comply with these disclosure requirements, whether or not they are relying on the federal pre-emption of state law.

Furthermore, some states require home equity credit line lenders to make additional disclosures to consumers.

Merrill Lynch Equity is concerned that the point may be reached (if it has not already been reached) where the various disclosures required by the various regulatory agencies with the commendable intention of assisting consumers, become so extensive and possibly duplicative, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures. Merrill Lynch Equity is also concerned about the cost to home equity credit line lenders, of complying with additional disclosure requirements. This expense might be passed on to the borrowers, resulting in higher costs to the borrowers, without a material improvement in borrower protection.

Some groups have advocated legislation which would go beyond assuring that consumers have full and fair disclosure regarding equity credit lines, and would regulate the specific terms upon which lenders could offer equity credit lines. These proposals would prohibit equity credit line lenders from utilizing terms which are common in conventional adjustable rate mortgage transactions.

Section 1204 of the Competitive Equality Banking Act of 1987 already requires that any adjustable rate mortgage loan originated by a creditor shall include a limitation on the maximum interest rate that may apply during the term of the mortgage loan. This legislation does not present significant problems for either borrowers or lenders, because it leaves the lenders free to set the interest rate caps at any level they choose. A borrower who desired a lower interest rate cap could select a loan from a lender which offered a lower interest rate cap. A lender which desired to offer other features and a higher interest rate cap, is free to do so.

Merrill Lynch Equity feels that the free market and the demand of borrowers for various products should determine what features lenders offer in equity credit line loans. This same free market, driven by consumer demand, has resulted in the availability of a variety of types of conventional variable rate mortgage loans which are attractive to both borrowers and lenders.

One area in particular in which commentators have called for further legislation is requiring lenders to set specific annual or lifetime caps on home equity credit line interest rates.

Merrill Lynch Equity believes that specific annual or lifetime caps on home equity credit line interest rates would be more harmful to both borrowers and lenders than would annual or lifetime interest rate caps on conventional variable rate mortgage loans. This is because borrowers could establish equity credit lines with annual or lifetime caps, but not draw the lines down unless interest rates rose significantly. If interest rates did rise significantly, so that the caps required that the equity credit line interest rates be significantly less than they would have been without caps (and less than market rates prevailing at the time), borrowers would have a great incentive to draw down funds on their equity credit lines.

Lenders would be paying high interest rates for these funds, but receiving the lower, capped rates. If the high interest rates continued, lenders would begin losing money.

This situation would have an adverse impact on availability of funds in the future, and on stockholders and any depositors of the lenders. If the lenders were federally insured, this situation could become costly for the federal insurers, and hence for all taxpayers.

This potential negative impact on lenders and the public is not nearly so severe in the case of caps on conventional variable rate mortgage loans, where the loan proceeds are advanced to the borrowers at the closing, and repaid by the borrowers over a number of years. This is because, in the case of conventional loans, the lenders would at least make some profit on the interest received during the period between the time that the loans were made, and the time that interest rates rose. Much of this profit would be unavailable to equity credit line lenders whose credit lines were capped, because, as indicated above, borrowers would not have the incentive to draw down heavily on capped equity credit lines, until such time as interest rates rose significantly.

Prudent lenders would not take these interest rate risks caused by capped equity credit lines, and instead would purchase some sort of interest rate hedges, in order to protect themselves from losses caused by rising interest rates. This would, however, be expensive, particularly if relatively low annual caps were required. The lenders would need to pass the cost on to the borrowers. The most logical way for lenders to recover some of these hedging expenses would be to charge borrowers significant up front fees for establishing equity credit lines.

Merrill Lynch Equity feels that it is important that all borrowers not be penalized by having to pay more for equity credit lines, merely because some borrowers may desire to pay more, in order to obtain equity credit lines with particular interest rate caps.

Reactions to H.R. 3011, the Home Equity Loan Consumer Protection Act of 1987

In general, Merrill Lynch Equity supports H.R. 3011, because it furthers the purpose of making full and fair disclosure to consumers regarding home equity credit lines, prior to the time that the consumers become obligated on a home equity credit line.

However, the disclosures required by this legislation, when combined with the disclosures already required, might result in such extensive disclosure, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures.

The chances of this adverse result to consumers occurring would be less if this legislation was revised so as to provide that the required disclosures were to be given in place of the disclosures required by other federal or state laws and regulations.

Reactions to H.R. 3468, the Home Equity Loan Disclosure Act of 1987

Merrill Lynch Equity supports the goals which this legislation is intended to achieve, and the disclosure provisions of this bill. However, Merrill Lynch Equity is concerned about the requirements regarding the terms upon which lenders may offer equity credit lines. These requirements could result in all borrowers paying significantly more for home equity credit lines, and could prevent borrowers from obtaining home equity credit lines on terms which might be appropriate for particular borrowers' circumstances.

* * *

Mr. Chairman, I would like to thank you for the opportunity to appear before your subcommittee today, and I would be happy to answer any questions you might have.

Statement
of the
National Council of Savings Institutions
on Home Equity Loans
Subcommittee on Consumer Affairs
Committee on Banking, Housing & Urban Affairs
United States Senate
November 18, 1987

The following statement represents the views of the National Council of Savings Institutions for today's hearings concerning various issues surrounding home equity loans.

The Subcommittee on Consumer Affairs is considering the question of the appropriate level of consumer protection necessary and is reviewing bills introduced in the House. The National Council supports the approach of Congressman David Price when addressing the consumer's need for proper disclosure of terms for home equity lines of credit (HELC). We do, however, oppose restrictions or limitations imposed on home equity lending programs which in turn could adversely affect lenders and the availability of the product for consumers.

Background

Home equity lending is an important refinement in the second mortgage products that our members have been offering consumers for some time. These loan products represent a healthy diversification of savings institutions' portfolios, since second mortgages are shorter term than first mortgage loans, and often carry variable rates of return. Second mortgages and home equity credit lines are financial products that today's consumer expects to find at leading providers of financial services.

As many institutions have attempted to diversify into consumer loan products such as car loans or credit cards, they have discovered a very competitive, crowded market. In the case of automobile loans, for example, the competition from captive finance subsidiaries of auto manufacturers offering "advertised" rates as low as 1% is stiff competition indeed. Savings institutions are ideally suited to offer home equity credit loans since well established consumer relationships (through first mortgage lending) and mortgage lending departments are the foundation for good home equity lending programs.

Home equity loans act as revolving lines of credit in which a qualified homeowner may draw on an established account. The maximum loan amount is based on two factors: the percentage of equity built up in the home and the ability of the borrower to make payments. Typically, home equity loans are used for home improvements, education, medical emergencies, and the purchase of major consumer items such as boats or cars, among others. HELCs differ significantly from previous revolving lines of credit in the fact that these loans are secured by the homeowner's dwelling.

Home equity loans offer the borrower features not available with unsecured or traditional loans. The first important benefit is cheaper rates. Since the loans are secured by real estate, the borrower can get funds at more attractive rates than are available for signature or unsecured loans. The second major feature is convenience. Since the line of credit can be established at one time, and drawn down as the borrower needs the funds, it is easier for an individual to manage his or her debt than otherwise would be the case. This is a major benefit over the traditional second mortgage.

1986 Tax Reform Act

Another important feature of these loans was recently added through actions of the Congress when it restricted the deductibility of interest or certain loans. Home equity loans have received much attention in media markets within the short time following the passage of the Tax Reform Act of 1986. This tax law will phase out interest deductibility for consumer credit by 1991. One exception still remains, however, and that is the ability to deduct interest incurred on debt secured by a taxpayer's primary

EXHIBIT A

Don't bet the house on it.

Can you afford to sell your house today and spend the money on a vacation? Or a luxury car? Most of us can't.

Yet many consumers will soon run the risk of doing just that with home equity lines of credit.

The new Tax Reform Act of 1986 makes these loans a powerful credit tool for homeowners. Under the new tax law, interest on these loans will remain tax-deductible. The interest deduction for consumer loans such as personal, auto and credit card loans will start to phase out this year. By 1991, no tax deduction will be allowed for interest paid on these consumer loans.

These advantages make home equity lines of credit a desirable product for many borrowing needs. Some will argue that the tax advantages alone are reason enough to replace credit cards and other consumer borrowing tools with home equity lines of credit. But you need to understand the terms of such a loan before "signing on the dotted line."

Although home equity lines of credit offer the convenience of revolving credit card accounts, combined with tax advantages, there is a crucial difference. Your house — the most important investment you own — serves as collateral for the loan. Such a commitment should not be taken lightly.

There are other important differences as well.

■ Home equity lines of credit involve much higher amounts, an obvious point. Yet the casual borrower could escalate credit spending beyond the family budget.
■ Most equity lines of credit have 15-year terms, much longer than credit card accounts. The longer term, which usually means lower monthly payments, may also lull the casual borrower deeper and deeper into debt.
■ The longer term makes it harder for you to predict your financial state throughout the period. What will your house be worth in 15 years? How much will you earn? Can you be sure of your health? Are you willing to bet the house on your guess?
■ Home equity lines of credit, like fixed home equity loans, involve up-front closing costs and appraisal fees, which vary from lender to lender. Some institutions even charge the borrower points — or a percentage of the amount borrowed.
■ If you want to increase your credit line later on, you may be required to pay the closing costs, fees and points all over again.
■ The interest rates, which are usually linked to the prime rate, are more variable than credit card rates. And given the size of the potential interest payments, it pays to shop around before you sign up for a line of credit.

All of these differences demand that you approach a home equity line of credit as you would another mortgage (which it is) rather than another easy source of credit. We suggest these prudent borrowing strategies:

■ Analyze your financial situation carefully before going to the bank. Consider your long-range financial plans and what role your home equity plays. For instance, are you counting on retirement income from the sale of the property?
■ Apply for the amount of credit you can afford — and no more. Resist the temptation to think of a home equity loan as an easy cash reserve. You may also be tempted to apply for the maximum amount to avoid additional closing costs later. This may make sense, if you know you can manage the maximum line of credit.
■ Adjust your payback period according to your purchase. It makes little sense to borrow money for a car and pay it back over 15 years. Even with the tax advantage, the car will cost much more than it would with a fixed-term conventional loan.

Instead, calculate the amount of principal you need to repay each month to pay off the loan in a reasonable period of time, or ask your lending institution to do it. Then pay that amount along with the finance charge, rather than the minimum payment.
■ Don't risk the family home for frivolous purchases. Although you may have always wanted to go on safari, ask yourself whether your house is worth a few snapshots of wild giraffes.

What are we getting at? Simple: Don't use this kind of credit to pay for things that are used up as soon as you buy them. They don't justify eroding your net worth — and that's what imprudent borrowing can do.

We hope you'll take these tips seriously when you apply for your home equity line of credit. GSB intends to work with you to structure a home equity line of credit that will meet your needs without endangering your home equity.

We know what your home means to you, both financially and personally. We want you to enjoy it for many years to come.

If you have questions or comments about home equity lines of credit, we invite you to write to:

Andrew McA. Hunter
Vice President
GSB
City Line & Belmont Avenues
Bala Cynwyd, PA 19004

GSB
GERMANTOWN SAVINGS BANK
SO MUCH MORE

EXHIBIT B

THE ONE EQUITY LINE OF CREDIT

IT CAN HELP YOU HANDLE YOUR MONEY BETTER

We think you'll find The One Equity Line of Credit the most versatile, easy to use loan you've ever had. And in order to help you use this loan to your best advantage, we've enclosed some valuable information designed especially for The One Equity Line clients. No matter how you plan to use your loan, now or in the future, these cards will give you some helpful suggestions on how to best use your home equity. We hope you find them useful. If you have any questions now or later, please just give me a call!

BUILDING A SECOND HOME

The One Equity Line of Credit can help you finance the construction of a second home or other recreational property.

Before you start, here are some suggestions you may want to consider:

-If you are considering the purchase of a parcel of land to build on, be sure to check with the local building inspector to determine what information or documentation is necessary to be sure that the parcel is buildable.

-Before purchasing the real estate, you should also contact an attorney to conduct a title search on the property to be sure that you will have a clear and marketable title.

-Check you city or town's building code to be sure that your project will be in compliance with any applicable ordinances and zoning requirements. Be sure to determine whether you or your contractor will be responsible for obtaining any permits, licenses or other municipal approvals and then make certain they are obtained.

-Contact more than one contractor to get written bids. You may be surprised at the vast disparity in price and time to complete between contractors for the same job.

-Get references on each contractor from people they have worked for and make a visual inspection of recent examples of their work. You may prefer one contractor's style and quality over another's.

-Contact an independent appraiser or REALTOR to determine whether the value of the property, once you complete construction, will not represent an over-improvement for the area.

-Make certain you understand the terms of the contract you sign with the contractor, especially concerning progress payments, payment of subcontractors, and the timeline for the project. If you have any questions at all, see your lawyer before you sign.

-Protect yourself against liens for non-payment of subcontractors by receiving lien waiver agreements from the contractor and any subcontractors. This will protect you in the event that the contractor fails to pay the subcontractor.

-Do not make the final payment until you are satisfied that the work complies with the terms of the contract. If necessary, negotiate a "Hold Back" amount with the contractor to cover work which must be corrected or modified, including a scheduled completion date by which the contractor must complete the work or forfeit an agreed amount. By retaining a certain amount of funds, you will be in a better position to have the work completed satisfactorily by a different contractor.

PURCHASING INVESTMENT REAL ESTATE

The One Equity Line of Credit can help you finance the acquisition of investment property.

Here are a few items you should consider before undertaking this investment:

-In order to protect your interests, an attorney should represent you. Your attorney can also conduct a title search of the property to ensure that the title is clear and marketable.

-Before purchasing the property, ask the seller for operating expense statements on the property. This can assist you in determining the earning potential of the property.

-Engage an independent appraiser to appraise your proposed purchase in order to determine if you are paying fair market value. (Maine Savings Bank can suggest independent appraisers if the property is located in Maine.)

-Determine whether any property improvements are necessary immediately or in the near future and include their projected costs in your expense calculations. Be sure to include any additional borrowing costs as well.

-Have an accountant go over the income statements on the property to ensure that you are aware of all tax implications and that the property will be a profitable investment.

-If the property cannot support a professional manager, consider the cost and time necessary for you to travel to and manage the property yourself.

COLLEGE EXPENSES

Use The One Equity Line of Credit to help you finance college, graduate school or other higher education.

Consider these facts before tapping the equity in your home for such expenditures:

-Even though your income may not permit the full borrowing for a subsidized Guaranteed Student Loan (up to $2,625 annually the first and second year and $4,000 annually the third and fourth year) don't automatically assume you are ineligible. Be sure to investigate that possibility thoroughly first by contacting your Maine Savings banker to explore your borrowing options.

-Don't assume that student loan requirements and eligibility guidelines will be the same every year. Fill out the financial aid forms each year to determine eligibility for a Guaranteed Student Loan or any other scholarship or grant programs the college may offer.

-Depending on the institution, you may be offered an alternative borrowing source directly from the school, or the school may provide some incentive if you elect to prepay any or all of the expenses for a particular program.

-Or you may wish to consider the Parental Loan Program of up to $4,000 per year, or, for independent students, the ALAS Program of up to $4,000 per year for graduate students and $2,625 per year for independent undergraduate students. These loans' fixed rates and longer terms may help to make the cost of education affordable while holding part or all of your home equity in reserve. Again, check with your Maine Savings banker about these options.

INVESTING OR BUYING A BUSINESS

The One Equity Line of Credit can be used to help finance the expansion or acquisition of a business, to invest in stocks and bonds, etc.

Here are some suggestions if you use your home equity for such investments:

BUYING A BUSINESS

-If you're thinking of buying a business, several years' income statements and balance sheets of the business should be analyzed to determine the viability of the business, the market for the products and stability of its customer base.

-Review the company's business plan carefully to determine if it is reasonable and its goals achievable.

-An accountant should be called in to review the balance sheets of the business.

-Your own attorney should always be consulted to protect your interests in any transaction.

-If you are using your equity as only a portion of the cash investment required, factor into your business plan the cost of additional borrowing.

STARTING A BUSINESS

-The same considerations for purchasing a business apply to the evaluation process in the decision to start a new business (see above), but because of the relatively high failure rate in new businesses, extra caution must be exercised and there must be additional funds available either through an unused equity line or outside sources.

-We do not recommend using advances against an equity line to start a new business unless income levels as shown in the original application are continued in order to service the loan in the event the business is not successful.

OTHER INVESTMENTS

-Investment strategies can target short-term growth or longer-term retirement goals. Consider IRAs, Keoghs, or SEPP plans. Talk to your Maine Savings banker to find out which option is best.

-Neither stocks nor bonds nor mutual funds involve guarantees of return or appreciation. Consider the consequences of losses as well as gains before you invest.

-To invest in stocks, bonds, mutual funds or other similar investment vehicles, you may wish to contact Winslow Investment Company, a subsidiary of Maine Savings Bank, for both advice and discount brokerage services.

-Talk to the people at Winslow Asset Management if you're interested in having a personal financial plan designed and managed for you.

HOME IMPROVEMENTS

You can use The One Equity Line of Credit to finance a home remodeling job or other home improvements.

Here are some suggestions to get you started:

-Contact more than one contractor to get written bids on your home improvements. You may be surprised at the vast disparity in price and time to complete between contractors for the same job.

-Get references on each contractor from people they have worked for and make a visual inspection of recent examples of their work. You may prefer one contractor's style and quality over another's.

-Check your city or town's building code to be sure that your project will be in compliance with any applicable ordinances and zoning requirements. Be sure to determine whether you or your contractor will be responsible for obtaining any permits, licenses or other municipal approvals and then make certain they are obtained.

-Contact an appraiser, REALTOR or other Real Estate professional to determine if the improvements will actually add value to your property. You may want to think twice if such a real estate expert feels your improvement will "over-improve" your property for the neighborhood, making it difficult to recover your investment should you decide to sell.

-Make certain you understand the terms of the contract you sign with the contractor, especially concerning progress payments, payment of subcontractors, and the timeline for the project. If you have any questions at all, see your lawyer before you sign.

-Protect yourself against liens for non-payment of subcontractors by receiving lien waiver agreements from the contractor and any subcontractors. This will protect you in the event that the contractor fails to pay the subcontractor.

-Do not make the final payment until you are satisfied that the work complies with the terms of the contract. If necessary, negotiate a "Hold Back" amount with the contractor to cover work which must be corrected or modified, including a scheduled completion date by which the contractor must complete the work or forfeit an agreed amount. By retaining a certain amount of funds, you will be in a better position to have the work completed satisfactorily by a different contractor should there be a problem.

CARS, ANTIQUES, ART, YACHTS...

Use The One Equity Line of Credit to write yourself a loan to finance larger purchases.

Here are a few things you should consider when purchasing other assets such as antiques, art, collectibles, a car, boat, etc.:

-Shop carefully. Be sure you are paying fair market value for your purchase.

-If purchasing a depreciating asset such as a car, boat or recreational vehicle, consider paying down the principal part of the loan balance (as well as the interest) on a regular basis so it is totally paid back in a reasonable period of time. Otherwise you may eventually be left with an outstanding debt which is much greater that the depreciated value of the asset.

-Your Maine Savings banker can set up a monthly amortizing payment schedule in order that your loan balance is "paid down" as your purchase depreciates.

-If purchasing an appreciating asset such as high quality jewelry, art or antiques, you should have these investments appraised to determine their market value. This will help to ensure that you are not over-paying for your investments, making it difficult to recover your expenditure should you decide to sell them at a later date.

-Be sure to maintain adequate insurance on all of your assets. Contact an insurance agent experienced with your particular assets to help you determine whether your assets are adequately documented and protected.

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

William M. Moore, President
Nestor R. Weigand, Jr., President-elect
Ira Gribin, First Vice President

William D. North, Executive Vice President
Stephen D. Driesler, Senior Vice President, Government Affairs
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777 14th Street, N.W., Washington, D.C. 20005-3271
Telephone 202 383 1000

December 1, 1987

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing and Urban Affairs
Subcommittee on Consumer Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the NATIONAL ASSOCIATION OF REALTORS®, I would like to thank you for this opportunity to comment on the topic of consumer disclosures for home equity lines of credit. We request that this statement be included in the record for the hearing conducted by the Subcommittee on Consumer Affairs on November 18, 1987.

The NATIONAL ASSOCIATION OF REALTORS® strongly advocates the standardization and strengthening of disclosure requirements to consumers for all loan products that are secured by a consumer's residence, such as a home equity loan. The credibility and viability of such a loan product can only be preserved by assuring that a proper balance is struck between its marketability, its ability to provide liquidity to homeowners, and the potential for risk. One of our chief concerns for the viability of home equity lending is the consumer's risk upon entering into such an arrangement. Because of the numerous features and options available under different home equity lending plans, the NATIONAL ASSOCIATION OF REALTORS® believes it important for potential borrowers to be able to fully compare and understand all of the features of the various loan products available.

The NATIONAL ASSOCIATION OF REALTORS® has consistently taken a strong policy position in favor of the provision of adequate, proper, and meaningful consumer disclosures. We strongly believe that adherence to disclosure requirements should be monitored closely by the appropriate regulators, and abuses should be corrected as quickly as possible. All parties -- lenders, consumers, and REALTORS® will benefit from a strong disclosure mechanism. The REALTORS® goal for this issue is to ensure that borrowers are fully informed as to potential risks and costs when they are using their residence as security for a loan.

EQUAL HOUSING OPPORTUNITY

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

In the U.S. House of Representatives, a bill that closely achieves the goal of adequate, proper and meaningful consumer disclosure has been introduced by Representative David Price (D-NC) and is entitled the Home Equity Loan Consumer Protection Act of 1987 (H.R. 3011). The NATIONAL ASSOCIATION OF REALTORS® supports each of the provisions of this legislation and respectfully submits the following additional provisions which we believe will provide an even greater degree of consumer protection:

Disclosure Recommendations

A. The bill would require the Board of Governors of the Federal Reserve System to prepare an informational brochure to describe "open-end" credit plans secured by the consumer's dwelling and the terms and conditions on which such loans are generally extended, plus a discussion of the potential advantages and disadvantages of such plans. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure be distributed as early as possible, (i.e. when a potential applicant initially inquires about a loan), and that this brochure should be provided directly to the consumer). We propose this early disclosure requirement because we believe it necessary for the consumer to have the greatest amount of time possible to compare different home equity loan plans.

B. The bill would require lenders to disclose up-front how changes to the Annual Precentage Rate (APR) will be determined, including the possible timing of such changes, and the source of the index used to calculate the APR, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also report the lender's margin. The disclosure of the lender's margin (that is, the amount that the lender will charge to the borrower over the index rate) will afford consumers the opportunity to compare the prices that different lenders charge for their loan products.

C. The bill would require lenders to disclose up-front the amount of all fees to be paid by the consumer, including annual fees, application fees, and discount points, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also include the amount of any late payment fees that a consumer may be required to pay. We believe that this information is necessary so that the consumer is made fully cognizant of the total extent of his or her financial responsibility for the loan obligation.

D. If the home equity loan plan involves a variable rate feature, the bill would require lenders to disclose the maximum amount that the APR may change in any one year period. The NATIONAL ASSOCIATION OF REALTORS® recommends that lenders be required to provide the consumer with sufficient advance notice if the APR is going to change. The NATIONAL ASSOCIATION OF REALTORS® recommends that such advance notice be required no less than 30 days prior to the rate change. It is important to note that this recommendation is not intended for up-front disclosure, rather, this recommendation would require the lender to provide advance notice to the consumer, during the term of the loan, that the interest rate for the loan, and thus the payments, are going to adjust. We believe that such an "advance-warning" requirement will enable consumers to better manage their financial obligations.

E. If the home equity loan plan involves a variable rate feature, the bill would require lenders to disclose the maximum APR that may be charged in any one year period. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also include the maximum amount that the APR may increase over the entire loan period.

F. If the home equity loan plan involves a variable rate feature, the bill would require lenders to demonstrate the actual loan payments for a sample $10,000 loan amount under the terms of the plan, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure, rather than rely on the sample $10,000 loan amount, be prepared with the specific loan amount requested in the loan applicant's application. The Association is supportive of the conceptual framework of the proposed hypothetical example and we do believe that an example based on the actual history of the particular index is a reasonable approach to this disclosure, however, the Association believes that a specific disclosure will prove more useful to consumers in comparing variable rate loans. While the legislative proposal would require lenders to include a statement on the disclosure form explaining to borrowers how to calculate the example for their particular loan amount, we continue to believe that an example based on the consumer's specific loan amount is the optimal method. The experience in the real estate industry is that borrowers relate more easily to specific facts and figures. An example, not readily specific, will be less meaningful to consumers.

G. The bill would require lenders to disclose, if applicable, a statement that explains that although a borrower may be permitted to make interest-only payments on the loan, and that while such interest-only payments may cost less on a monthly basis, such a loan feature: does not retire loan principal; prolongs the obligation; and results in a greater total expense over the life of the loan. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure include an explicit statement that an interest-only feature, or a negative amortization feature can mean lost equity for the homeowner.

H. The bill would require that any advertisement for a home equity loan provide: the amount of any charges that may be imposed; the finance charge of the plan, expressed as an annual percentage rate (APR); the amount of any membership or participation fee that may be imposed; a statement that interest expense may not be completely deductible for all taxpayers; and, a prohibition on the terms, "Free Money", and "Loan at Prime". The NATIONAL ASSOCIATION OF REALTORS® recommends that if applicable, the advertisement should also disclose the amount of any potential, or scheduled, payment increases.

Conclusion

We hope that this information will be of assistance to you as the Subcommittee on Consumer Affairs conducts further hearings and deliberations related to this important topic. As always, please let us know if the NATIONAL ASSOCIATION OF REALTORS® may provide your subcommittee with any additional information.

Sincerely,

Stephen D. Driesler,
Senior Vice President

cc: Peter Kinzler, Counsel,
Subcommittee on Consumer Affairs
The Honorable David Price

and secondary residence, within the limitations of the 1986 Tax Reform Act.

When speaking about the ramifications of the Tax Act on the second mortgage markets, it is important to remember that only 37% of taxpayers currently itemize their deductions, and this number should go down after the new tax law takes full effect. However, the restrictions on tax deductions for traditional consumer loans have created a greater demand for an alternative product which will help consumers replace some of the tax advantages previously available for credit card, automobile, and other personal loans.

Recently, legislators and regulators have been concerned with borrowers' increased exposure to the risk of losing their homes due to an inability to repay the home equity loan. The National Council shares this concern. Clearly some of the hard sell advertising for home equity lending has been unfortunate, but it appears that such advertising is an exception, and not the rule. We are attaching for your review as Exhibit A an ad that one of our members, the Germantown Savings Bank, has used. This is representative of much of our membership's approach to this important financial product.

Need for Consumer Awareness

Because a home is the most important investment made by most, any loan agreement which could affect such home ownership should be thoroughly understood and assessed by the consumer. Another of the Council's members, the Maine Savings Bank, hands out a booklet with important practical advice to potential home equity borrowers. The entire text of the booklet is attached as Exhibit B.

It is important in today's increasingly complex mortgage marketplace that proper and understandable information be provided to any potential borrower. The National Council has supported past efforts to educate consumers on the mechanics of various mortgage products. In 1984, the National Council worked in conjunction with other industry trade groups, the Federal Reserve, and the Federal Home Loan Bank Board to develop the

Consumer Handbook on Adjustable Rate Mortgages. This consumer information brochure has proven to be the most useful tool in describing the ARM. We will continue to support similar educational efforts for home equity loans.

The Council recently sponsored a program for the industry on Home Equity Credit Lending, and placed a high priority on emphasizing the consumer's concerns in this line of business. We heard from Congressman Charles Schumer and a representative of Consumers Union to underscore the importance of the consumer's best interests.

Market Experience

As the Congress approaches the question of necessary consumer safeguards in the home equity lending area, it is important to keep certain things in perspective. First, the highly visible marketing of these programs is very competitive as providers of financial services attempt to maximize lending programs that many feel will be spurred on by the new tax law. However, a recent survey taken by the Survey Research Center (SRC) of the University of Michigan on behalf of the Consumer Advisory Council of the Federal Reserve shows that, "As of April 1987, 6% of homeowners had established lines of credit secured by their homes. In addition, 1% of homeowners had applied for such accounts but had not yet received approval."

The SRC survey also shows that, "Consumer awareness of the availability of HELC is high (80% of all homeowners stated they knew about such accounts). However, nine-tenths of homeowners who were aware of such accounts but had not yet applied for one stated that they were not interested in opening such an account in the near future."

Second, a major portion of the home equity lending business will represent a substitution of consumer debt transferred from credit card, automobile, boat, and other unsecured personal loans. This transfer of debt will represent a savings to the consumer in the form of cheaper borrowing costs. This is also borne out by the SRC study.

As the Congress addresses the issue at hand, the Council would urge that no restrictions be placed on the ability of lenders to structure loan products, as this will stifle market development. Since the introduction of home equity loans, there has been experimentation and product development by the industry in addressing problems that may still exist. As with any new mortgage-related product, there is bound to be the need for a revising and tightening of underwriting methods, marketing strategies, product design and proper disclosures for consumers.

ARM Comparison

If we simply look back a few years to when adjustable rate mortgages (ARMs) were the latest mortgage instruments, we can see many of the concerns addressed then resurfacing today with regard to home equity loans.

The early stages of ARM introduction met with borrower resistance. Few borrowers were willing to accept the ARM without protection against unrestricted interest rate increases. To remain competitive, creditors were forced by the market to adjust their product to include lower initial interest rates, annual and lifetime rate caps.

It cannot be overemphasized that a mutually beneficial ARM product for both lenders and borrowers must be developed without restrictions imposed by Congress and regulators. The outcome of extensive lending restrictions can be seen when reviewing the history of ARMs. Between 1978 and 1983, the Federal Home Loan Bank Board placed severe interest rate restrictions and disclosure requirements on ARMs, stopping many federally chartered savings and loans from offering the product because they could not remain competitive under those conditions. Although these restrictions were imposed to protect consumers, the effect was to prevent lenders from offering an adjustable rate product, thus denying consumers access to this type of financing. The major development in the ARM market came after the restrictive regulations were rescinded. In fact, the most popular ARMs contain consumer protections in terms of annual and lifetime rate caps, but these were developed by the market, not dictated by the government.

Today, consumers are becoming more sophisticated in their knowledge of new variable rate mortgage products. They are exhibiting extreme caution when undertaking large debt, especially debt which is secured by their homes. As was shown with the ARM example, borrowers will not accept a product which poses substantial risk. Lenders work to provide a stable and efficient instrument that reduces overall costs and minimizes losses due to foreclosure. It is not to the lender's advantage to offer a loan product which will be impossible for the borrower to repay. Foreclosure on a property can cause serious losses for both consumers and lenders.

We feel a market-determined home equity loan is the best solution to any problems arising today. We therefore urge Congress not to restrict lending practices, but to allow the market to dictate a workable home equity product. We wish to commend Congressman Price for introducing a bill which keeps a realistic perspective on the home equity lending market, and addresses potential problems through better informing the consumer and not through the imposition of arbitrary restrictions on the market.

The action taken by Rep. Price and the hearings being held by this Subcommittee are timely actions that will clearly help the regulatory process receive important Congressional input. In the near future, the Consumer and Community Affairs staff of the Federal Reserve is expected to submit to the Board for approval a proposed rule on open-end credit disclosure requirements. We look forward to working once again with the Fed staff in this area.

The National Council would like to thank the Subcommittee on Consumer Affairs for the opportunity to summit our statement on home equity loans and ask that it be included as part of the record for today's hearing.

USL
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PHILIP GASTEYER
Executive Vice President
& Director of Washington Operations

November 16, 1987

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Consumer Affairs
Senate Committee on Banking, Housing
and Urban Affairs
Room 534
Dirksen Senate Office Building
1st and C Streets N.E.
Washington, D.C. 20510

Dear Senator Dodd:

The U.S. League appreciates this opportunity to share with you and members of the Subcommittee our views on home equity lending. A review of home equity lines of credit is not only timely, but understandable and commendable. Because Internal Revenue Code changes will soon render home equity loans the only source of interest-deductible consumer credit, we have seen a considerable expansion of this type of lending. As a result, I do not doubt that there have been instances of their over-promotion and under-disclosure. Given the fact that home equity lending by its nature involves placing liens on consumers' homes, typically an individual's most important asset, we wholeheartedly agree that it is appropriate for Congress to review the area for abuse and explore whether existing consumer protection mechanisms are adequate.

We would point out at the outset, however, that proper disclosure of credit terms -- particularly regarding open-end credit, variable rate credit, billing error rights, advertising and the right of rescission -- is required under the Truth-in Lending Act. Further, we would note that Section 1204 of the Competitive Equality Banking Act of 1987 requires that all adjustable-rate mortgage loans, including home equity loans, must include a ceiling on the maximum interest rate that may apply during the term of the loan, effective December 9, 1987.

It is the League's view that most of the concern about home equity lending stems from fear about what consumers _might_ do to damage themselves financially rather than from actual knowledge about what homeowners _are_ doing in the marketplace. Our experience is that homeowners are approaching home equity credit in a cautious and conservative manner, and this appears substantiated by survey data developed in 1987 for the Federal Reserve Board by the Survey Research Center of the University

THE AMERICAN HOME THE SAFEGUARD OF AMERICAN LIBERTIES

of Michigan, and for the Consumer Bankers Association by the Center for Financial Services Studies of the McIntyre School of Commerce of the University of Virginia. For instance, the Michigan study showed that 80% of all home equity borrowers had used only 50% or less of their available credit line, and the Virginia survey, in looking at variable rate borrowers, found the average person had accessed no more than 57% of his or her contractually available home equity credit. Indeed, many borrowers seemed to regard their home equity line as a special or even emergency credit source. This is reflected by the fact that home improvements were cited by both studies as the most frequently mentioned use of borrowed funds, and by the finding of the Michigan survey that, when asked, 31% of respondents reported no use of the credit line, more than 50% indicated no borrowing in the previous six months, and 20% showed only a single instance of borrowing.

The survey data reflected care on the part of lenders in granting home equity credit lines. The Virginia survey revealed that loan-to-value ratios approved for variable rate home equity loans, including the first mortgage balance, average less than 70% -- a very prudent approach to underwriting. Prudent underwriting also was revealed by that survey's profile of the typical borrower: an individual between 35 and 49 years of age, earning $44,000 annually, who has been a homeowner for over 9 years.

That prudence and restraint on the part of both borrowers and lenders are the hallmark of the home equity credit arena is perhaps best illustrated by the very low incidence of delinquency and foreclosure revealed by the Virginia study. Delinquencies were 30% less than for all consumer debt, and the institutions surveyed averaged only 1.5 foreclosures annually.

These figures do not bespeak abuse. Rather they underline one of the central economic facts of home equity lending: Namely, that lenders like this line of business because the set of borrowers basically is self-selected for quality. People who have built up home equity against which they can borrow are, on the average, fiscally conservative people who can be relied upon not to attempt to shoulder undue financial burdens that ultimately may prove damaging to themselves and their creditors. It is this quality factor, buttressed by intelligent underwriting, that is the lender's primary economic safeguard in this context -- seeking to recover a debt through foreclosing on a mortgage lien, especially a junior lien, is an expensive, time-consuming and acrimonious process.

Under these circumstances, we strongly feel that the most appropriate Congressional response is to ensure that disclosure mechanisms are in place that will assure that consumers of this financial product have the information they need to make an informed decision. The U.S. League would oppose steps that would be aimed at dictating other aspects of the home equity loan relationship, such as legislating specific rate caps, banning termination clauses, establishing maximum loan-to-value ceilings and forbidding negative amortization. The marketplace, drawing on clear and meaningful disclosures, will generate a far more useful and flexible product range for consumers than would emerge from a regime of statutorily dictated contractual terms.

We would object in particular to any legislation establishing specific interest rate limits for home equity loans, whether in terms of dictating the number of basis points by which rates could increase, employing an approach allowing rate adjustments to apply only on a go-forward basis, or mandating the duration of initial rates. The marketplace for financial services is a very competitive one, and, as long as consumers have adequate information available, they will find suppliers of products suited to their needs. In the home mortgage field, for example, fixed-rate instruments remain a fixed presence, notwithstanding the dire predictions of those who resisted the authorization of adjustable-rate loans.

Indeed, we believe that the widespread popularity of adjustable-rate mortgages in the past four years made homeownership a reality for many American families who could not otherwise afford mortgage credit -- thus making a very significant contribution to housing's recovery from the 1981-82 spiral of interest rates. As you know, adjustable-rate loans are marketed at a significant entrance discount over fixed-rate mortgage loans. According to estimates of the U.S. League's Economics Department, as many as 1.4 million more new and existing homes were sold in that period than would have been sold if only fixed-rate mortgages had been available to homebuyers.

It should be emphasized that, in a marketplace where the interest rates on deposits have been deregulated, it would be a serious mistake to return to the practice of legislatively restricting, in effect, depository institutions' return on assets. We in the thrift industry paid a severe price for this sort of one-sided financial regulation in the past. Please bear in mind that financial controls of this kind, in addition to damaging suppliers of credit, also harm those who must consume it, for such restrictive practices invariably limit the availability of credit and increase its cost. The only individuals who profit are those persons who reap the windfall benefit, ultimately subsidized by others, of enjoying financing terms inconsistent with changes in market conditions.

Regarding the termination clauses, we would note that such provisos are long-standing features of open-ended consumer credit arrangements, and are a necessary safeguard for creditors. Initial credit-line authorizations in open-end home equity lending may lay dormant for several years before being exercised by the borrower, during which time the condition of the underlying property securing the loan or other circumstances may change materially. We regard the abuse of the termination clause as highly unlikely, given state law protections and the general difficulty, expense and bad publicity associated with the foreclosure process.

As noted earlier, loan-to-value ratios in home equity credit extensions appear to be at very prudent levels; accordingly there seems to be no evidence adequate to justify legislating in this area. In any event, we believe quite firmly that lenders and consumers are far better equipped than any government body to decide what proportion of a borrower's home equity prudently may be tapped to satisfy his or her credit needs.

Likewise, the negative amortization issue is one best left to the good judgment of the parties to the transaction. In some cases, a transaction that involves a degree of negative amortization, all things considered, may be the one best suited to the consumer's particular needs. We see no virtue in interfering with persons wishing to enter into such arrangements, particularly in the absence of a record of abuse.

Given our concerns about unnecessary and counterproductive governmental intrusion into the home equity lending process, we believe any legislative initiatives in this areas should focus on disclosure, reflecting traditional Congressional preferences. Our preference, however, would be for Congress to defer any legislation at this time in light of the Federal Reserve Board's ongoing efforts in this area. Congress should not lose sight of the fact that the Truth-in-Lending Act, as administered by the Federal Reserve, has proved to be a powerful, dynamic and flexible tool for assuring informed consent. In particular, we note that Congress, in the form of section 125 of that Act, has mandated a right of rescission applicable to home equity loans secured by the borrower's principal dwelling. Consumers are given a three-day period during which they can back out of such a transaction without charge, should they change their minds. This right, together with current disclosure authority, strikes us as representing an adequately protective regulatory regime.

In developing disclosure requirements, we would hope this Subcommittee would be mindful of the existing Truth-in-Lending requirements in Subpart B of the Federal Reserve's Regulation

Z. We strongly urge that the Subcommittee work with the Federal Reserve to assure that any new legislation does not overlap with existing law and generate redundant and expensive new paperwork requirements. Not surprisingly, these disclosure burdens fall most heavily on the smaller, neighborhood and community institutions.

As a second matter, we urge that any special disclosure requirements should apply only to the borrower's principal residence. The particular concern in Congress over home equity loans strikes us as centering on the possibility that an individual in default may lose his home. We suggest that the possibility of losing investment or vacation property is not an issue meriting special attention within the Truth-in-Lending context.

A third point of concern involves disclosure timing. We suggest that requirements for disclosure for home equity loans be made consistent with those governing closed-end credit, thus allowing consumers to obtain all relevant information at one time. This could be accomplished by requiring the home equity line disclosures to be made before the first transaction or within three days of the application, whichever is earlier.

In this regard, but as an aside, the U.S. League has long felt that the best point for Truth-in-Lending disclosures in the chain of events in a home purchase may well be when the prospective purchaser receives the professional services of the real estate agent. That is often the point when credit is arranged. It continues to strike us as remarkable that, by law (as provided by section 702 of the Garn-St Germain Act), real estate agents are exempted from consideration as "arrangers of credit." While we appreciate that home equity loans occur after the time of initial purchase, it is our view that the more general question of the appropriate time for disclosure deserves your Subcommittee's attention in the general context of Truth-in-Lending.

Our fourth suggestion is that any legislation be adjusted to limit to the application stage the "conspicuous segregation" requirement relating to the new home equity disclosures. This would reduce the need for extensive and expensive changes in standard disclosure statements, without sacrificing disclosure effectiveness.

Finally, we believe that existing advertising requirements are adequate to curb abuses in this area.

In conclusion, Mr. Chairman, we believe this product is proving to be a very useful one for both lenders and borrowers, enabling the latter in particular to have more convenient access to their most significant asset -- the equity in their homes. While we are confident that on the strength of the record of this hearing you will be content for the time being to let the Federal Reserve deal with the situation under existing law, should the case be otherwise, we would be privileged to work with you to strengthen disclosure requirements.

Again, the U.S. League appreciates this opportunity to provide the Subcommittee with our views. If we may be of any further assistance, please feel free to contact me.

Sincerely,

Phil Gasteyer

Phil Gasteyer
Executive Vice President &
Director of Washington Operations

Statement of

David H. Pohl
Senior Vice President
Gibraltar MoneyCenter, Inc.
San Diego, California

For The

American Financial Services Association

Before The

Subcommittee on Consumer Affairs
Of The
Committee on Banking, Housing and Urban Affairs
United States Senate

On

Home Equity Lending Practices

November 18, 1987

Mr. Chairman, Members of the Committee, I am David H. Pohl, Senior Vice President of Gibraltar MoneyCenter, Inc. of San Diego, California, and Chairman of the Real Estate Lending Section of the American Financial Services Association (AFSA)*.

I appreciate the opportunity to have our views on home equity lending placed in the hearing record. I would like, first, to define some of the terms which are commonly used to describe home equity lending; second, to discuss some of the criticisms of home equity lending products and third to discuss how these products are regulated.

Home Equity Loans - Definitions

The term "home equity loan" refers to any loan secured by residential property other than the primary loan to purchase the property. Although many believe that home equity lending is a relatively new phenomenon, its roots can be traced to the late 1800's when building and loan societies used this method to help people buy homes. Home equity lending has long been a major type of lending for many AFSA member companies. However, the predominant form of home equity lending was and still is the closed-end, fixed-rate loan, also widely known as the "second mortgage". Only within the last few years have more and more lenders begun to offer open-end home equity lines of credit.

In numerous recent articles and discussions on the subject, broad-brush characterizations have been made about all home equity loans. Quite often, no effort is made to distinguish the closed-end, fixed-rate loan (the traditional second mortgage) from the relatively new open-end home equity lines of credit. These types of loans have inherently distinct characteristics, but are similar in the respect that they are loans secured by the owner's interest in residential real estate. Both fall into the generic category of "home equity loan".

To maintain consistency throughout this testimony, I will use the following terminology:

TERM	DESCRIPTION
Second Mortgage:	Closed-end fixed-rate or variable rate loan secured by consumer's dwelling.

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*AFSA is the nation's largest trade association representing nonbank providers of consumer financial services. Organized in 1916, AFSA represents a diversified group of companies ranging from independently-owned consumer finance offices to the nation's largest financial services, retail and automobile companies.

TERM	DESCRIPTION
Home Equity Line of Credit:	Open-end, variable rate or fixed-rate loan secured by consumer's dwelling, which can be accessed by cash advance, check or credit card.
Home Equity Loans:	Generic term describing second mortgages and home equity lines of credit.

Over the last decade, home equity loans have become increasingly popular. For example, among a representative sampling of AFSA members, home equity loans outstanding grew from $2.4 billion in 1977 to $15.9 billion in 1986.

More recently, home equity lines of credit have caught consumers' imagination as more financial institutions offer these products. The 1980 technical amendments to the Truth-in-Lending Act, which made revolving credit products feasible, made their growth possible. Home equity lending has skyrocketed from $5 billion in outstanding loans in 1971 to over $150 billion in 1985 (according to data published by the Federal Home Loan Mortgage Corporation). According to Moebs Services, a Lincolnwood, Illinois research firm, outstandings exceed $225 billion.

Consumers like home equity lines of credit because they provide a relatively inexpensive and readily accessible source of funds. Consumers can borrow as much or as little as needed depending on the size of their credit line and the minimum advance requirements set by the lender. According to a recent Federal Reserve Board survey, conducted by the University of Michigan's Survey Research Center (the Fed-Michigan survey), consumers most often use home equity lines of credit to consolidate debt, make home improvements, purchase automobiles and to defray educational and medical expenses.

These products provide a source of credit which "travels" with the homeowner, thereby ensuring a reliable, easy, and low-cost method to gain access to funds when needed.

Financial institutions like home equity lines of credit because they historically have a low delinquency rate and, because of their large size in comparison to other consumer loans, have a lower cost to loan-dollar ratio. Home equity lines of credit attract a more upscale and sophisticated customer who may continue to utilize other services offered by the financial institution.

While AFSA's traditional membership - consumer finance companies - have been involved in home equity lending for a long time, it still is a fledgling product line in other sectors of the financial services industry. From AFSA's viewpoint, our competitors are only now learning what we have known for years --

that home equity lending is both attractive and beneficial to consumers as well as safe and profitable for financial institutions.

In fact, the soundness of home equity lending is clear. For example, in contrast to personal loans at finance companies, second mortgages show much lower delinquency and default characteristics. AFSA research department data showed that 1.79% of finance companies' home equity loans (primarily traditional closed-end second mortgage loans) were more than 60 days delinquent. By comparison 60 day delinquency in unsecured lending was 4.15%.

To further illustrate the lower delinquency of home equity lending, the U.S. League of Savings Institutions' 1986 Consumer Lending Survey showed 0.8% of noncredit card-accessed open-end equity loans and 2.3% of credit card-accessed open-end equity loans were more than 30 days delinquent. Delinquencies for first mortgage loans are running much higher. The Mortgage Bankers Association's national delinquency survey reported that 5.33% of all one-to four-unit residential mortgage loans were more than 30 days delinquent as of December 1986.

The variable rate feature that characterizes most home equity lines of credit is an added attraction to lenders seeking to protect their portfolios from periods of volatile interest rates.

AFSA Supports Consumer Education

Naturally, AFSA is very concerned about advertising and lending practices which may reflect adversely on the integrity of this business. For that reason -- AFSA supports full, clear and accurate disclosure of home equity loan terms, in a manner that is meaningful to both the borrower and potential borrower.

Beyond supporting the objectives of the Truth-in-Lending Act (TILA), AFSA has taken steps to contribute to consumer awareness of the nature of these products.

AFSA is conducting a consumer education program which alerts consumers considering applying for a home equity loan:

- That such loans entail a security interest in one's home.
- That variable rate and payment plans should be analyzed to see how they fit in one's household budget.
- That consumers should seek competent tax advice.
- That consumers should shop for the terms and conditions which best meet their needs.

This program has received wide-spread attention in the press. (*See* appendix)

AFSA upholds a Code of Ethics, a condition of membership in the Association, that emphasizes complete and accurate advertising and disclosure of loan terms. Two provisions of the Code are particularly appropriate:

- o Members will explain fully to customers the cost, terms, and contractual obligations of credit transactions. Written instruments will be as simple, lucid, and unambiguous as circumstances will permit.
- o Truth in advertising will be the guiding principle of all promotional efforts thus enabling potential credit users to make an intelligent marketplace decision.

Additionally, the Federal Trade Commission, which remains the primary federal regulator of most AFSA members, has given AFSA permission to reprint and distribute copies of their manual "How To Advertise Consumer Credit". In sum, AFSA is mindful of consumer information, advertising and disclosure practices in promoting home equity loans and continues to advocate adherence to such standards.

Home Equity Lending Under Fire

Recently, two consumer groups have called on Congress to enact increased disclosure requirements for home equity loans. Their proposed measures would also prohibit balloon payments and negative amortization plans. AFSA believes that these proposals are based on the following implied assumptions:
(1) there is a widespread problem with disclosure and advertising by financial institutions offering home equity loans; (2) consumers are too unsophisticated to understand the consequences of their actions; (3) lenders do not disclose terms and conditions in order to gain ownership of the security; and (4) home equity lending is now substantially unregulated.

These assumptions are false.

Lenders Disclose Terms And Conditions And Corply With Advertising Standards

Lenders comply with a host of state and federal disclosure statutes and regulations. If anything, we are now approaching the point where consumers are being confronted with "over-disclosure". In each home equity transaction, a borrower is given a voluminous amount of paper work. As described later, disclosure requirements are already prevalent for home equity lines of credit on the federal and state levels.

Advertising of home equity lines of credit has especially irritated consumer groups. One group stated in a May 11, 1987 press release that "banks are heavily promoting these credit lines by promising the good life with easy repayment terms. But instead, they'll keep consumers in a perpetual state of debt and eat away at the major source of consumer savings, the equity in the home."

Naturally, advertising is designed to sell products. The question is whether eye-catching ads encourage inappropriate financial behavior. No evidence has been proffered to suggest that advertising has produced any frivolous behavior with respect to actual uses of home equity lines. Further, no responsible lender condones misleading advertising. The recent Fed-Michigan survey indicates rational uses of the lines of credit by borrowers.

Consumers Are Sophisticated Borrowers

The consumers who enter into home equity transactions are sophisticated enough to understand the ramifications of the transactions. They understand that the loan is secured by their home; they understand that variable rates mean variable terms and they understand the tax consequences.

The American Banker newspaper reported in its May 12, 1987 edition that "consumer groups contended that many homeowners fail to understand the risks of home equity loans or to appreciate fully that they could lose their homes if they default on the loans." However, the consumer groups' press releases do not offer any support for this contention.

Even a casual reading of advertisements or the trade name of the products themselves, typically "home equity access account" or "home equity line", indicates that a home is involved. The TILA requires ample disclosures, discussed below, and provides for a three-day right of rescission.

Furthermore, the nature of the transaction with the need for appraisals, mortgage documents, and the like is similar to the consumers' initial mortgage application and closing process.

Recent data indicate that home equity line holders are sophisticated consumers. While AFSA research department data show that approximately 80% of traditional second mortgage borrowers have annual incomes of less than $36,000, the Fed-Michigan survey found that equity line holder's median education was 14 years with a median income of $40,000 and median home equity of $70,000. This appears to be hardly a group which would "fail to understand the risks of home equity lines", as the consumer groups contend.

The Fed-Michigan survey respondents were asked whether enough information was provided by the lender at the time the account was opened. Over 90% of the line holders reported they had received all of the information they needed to make an informed decision.

Lenders Are In Business To Make Loans

Lenders have no desire to enter into transactions which lead to foreclosures. In fact, lenders will do everything possible to inform borrowers about the product in order to avoid any future problems. In deciding whether to grant such loans, lenders evaluate the creditworthiness of the applicant -- whether that person has the willingness (shown by past credit history) and the ability (shown by income) to repay the loan. A practical reality in the home equity lending business is that lenders have no desire to foreclose on a secured property. In most cases, foreclosure proceedings lose money for the lender.

Home equity lenders are in the lending business -- not the real estate business -- and are in business to make viable loans which a customer will renew.

Finally, if the borrower does encounter difficulty with meeting his obligations, responsible lenders will generally attempt to restructure the loan to avoid foreclosure.

Home Equity Lending Is Highly Regulated

Financial institutions' advertising and the offering of these products must comply with a myriad of state and federal laws. For example, the following is a brief summary of applicable laws that a lender must consider before launching a home equity loan program.

The TILA (and Regulation Z which implements the Act) applies to any consumer transaction secured by real property used or expected to be used as the consumer's principal dwelling.

Two provisions directly relate to the initial disclosure statement required by Regulation Z. One requires that special disclosures be made for variable interest rate products. A lender offering a variable-rate product must disclose, in the initial disclosure statement, circumstances under which the rates may increase, any limitation on the increase, and the effects of the increase. The second provision permits the exclusion of certain closing costs from the finance charge (as in all real estate secured transactions).

Regulation Z governs home equity loan advertising. The open-end credit advertising rules provide that the use of certain terms trigger a requirement to disclose certain other key fees and charges that may be assessed in connection with a lender's credit program. One term that triggers these additional disclosures is that which indicates that the lender would, in granting the loan, acquire a security interest in the borrower's home.

Perhaps the most dramatic TILA provision is the consumer's right to rescind the entire transaction within three business days. This applies when the credit plan is opened, when a security interest is increased to secure an existing plan, or the credit limit of the plan is increased.

The right to rescind exists for three business days following the last of three specified events. These events include the occurrence which gives rise to the right of rescission, the delivery of the rescission notice required under the provision, or the delivery of all "material disclosures". If a lender fails to comply with these requirements, the borrower retains the right to rescind for a period of up to three years. A borrower may waive the right to rescind only in a bona fide personal financial emergency.

The Equal Credit Opportunity Act (and Regulation B which implements the Act) also contains detailed rules about information that a lender can request from an applicant for a home equity loan.

Disclosures required under state law also generally apply to a federally-chartered or insured lender's home equity loan program unless the required disclosures conflict with federal law.

State disclosure requirements affect almost every phase of a home equity loan transaction. For example, at the application or preapplication stage, special disclosures similar to the initial disclosures required by the Office of the Comptroller of the Currency's ARM regulation and the Federal Home Loan Bank Board's regulations may be required concerning the terms and conditions of the home equity loan.

Similarly, state "plain English laws" may govern the transaction. Certain terms, such as a due-on-sale clause, may be required to be disclosed in particular documents to be effective. Further, advance notices may be required of adjustments in the interest rate on the account. Finally, disclosures peculiar to delinquent accounts may be required under state law, such as "right to cure" notices prior to the acceleration of any outstanding account balance and special disclosure requirements prior to the initiation of foreclosure proceedings. In addition to disclosure requirements, state laws may address fees and charges.

The marketplace -- through the operation of the secondary market -- exerts a disciplinary force on lenders by encouraging the standardization of documents and underwriting standards. Although the secondary market for equity loans is not yet fully developed, it has and will continue to have an increasing influence on lenders' programs. These standards provide an incentive to use prudence in all aspects of home equity lending. After all, the bottom line for the secondary market is to ensure a minimal amount of loan defaults. Disciplinary forces exerted by the secondary market should not be discounted in determining the need for further regulation of this industry.

No Data Support Additional Legislation

Other than anecdotal citing of "horror cases", no major study has been undertaken to show the need for additional regulation. Many homeowners enjoy the benefits of home equity products. No evidence has been advanced that further protective legislation is required.

As discussed earlier, home equity lines of credit are a relatively new innovation available to consumers. As such, evidence is just beginning to be assembled on the scope of the home equity lending business such as, how many financial institutions are offering the product, how many consumers have utilized the product and to what extent have the lines been exercised. It was only in July of 1987 that the Federal Reserve Board began to collect separate data on the amount outstanding extended under home equity lines of credit by banks.

While efforts are continuing to collect and analyze as much data as possible, it may be too early to draw vast conclusions about any aspect of open-end home equity lines of credit.

All available evidence suggests that consumers are pleased with home equity lines of credit and have not encountered any significant problems with them.

AFSA believes that this Committee should consider additional legislation only if such legislation does not inhibit the positive growth of home equity lines of credit.

Conclusion

AFSA is willing to work with your Committee in addressing these concerns. Thank you, Mr. Chairman and Members of the Committee, for this opportunity to file this statement for the record.

○

S. Hrg. 100-353

HOME EQUITY LOANS

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE ADVANTAGES OF LOANS FOR CONSUMERS OVER OTHER FORMS OF CREDIT, SUCH AS: TAX DEDUCTIBILITY; ATTRACTIVE INTEREST RATES; THE USE OF LINES OF CREDIT; AND 10- TO 15-YEAR PERIODS TO REPAY THE LOAN. ALSO THE NEED FOR SAFEGUARDS TO AWARE THE CONSUMER OF POSSIBLE FORMS OF AGGRESSIVE AND MISLEADING ADVERTISING AND TO INFORM BORROWERS, MANY OF WHOM ARE ELDERLY PEOPLE, THAT THEIR HOME IS AT STAKE AND COULD BE FORECLOSED

NOVEMBER 18, 1987

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
80-234 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
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HOME EQUITY LOANS

WEDNESDAY, NOVEMBER 18, 1987

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Consumer Affairs,
Washington, DC.

The subcommittee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Proxmire, Sanford, Wirth, and Chafee.

OPENING STATEMENT OF SENATOR DODD

Senator Dodd. The Subcommittee on Consumer Affairs will come to order.

This is the second of three subcommittee hearings addressing the ability of consumers to plan their financial affairs in today's world.

At the first one on November 5, the subcommittee examined some of the dramatic technological and societal changes of the past decade. In general, we found that consumers have to deal with far more products with far less time.

Today, we are going to examine one of the fastest growing new credit products, the home equity loan. While such loans have been around for several years, they did not take off until after passage of the Tax Reform Act of 1986. Because that act phased out the tax deductibility of interest for nonmortgage consumer debts, lenders and borrowers have turned more and more to the home equity loan as a substitute for other loans.

The home equity loan has obvious advantages for consumers over other forms of credit. Tax deductibility, attractive interest rates, the use of lines of credit, and 10 to 15 year periods to repay the loan are just a few of the features that have made home equity loans a very hot property indeed.

While estimates as to the amount of home equity outstanding range from $70 billion to $170 billion, everyone agrees that the amount of outstanding credit has just about doubled over the past year.

If the product has so many virtues and is so popular, why then is this subcommittee holding a hearing? The answer does not lie in any investigations revealing major problems. Rather, it lies in our concern about trying to avoid some problems. Our basic concern is that a home equity loan is, by definition, secured by a person's home and any inability to repay the loan, whether it is caused by a runup in interest rates, a death in the family, or unexpected major medical expenses, could obviously cause the borrower to lose his or her own residence.

One needs only to remember the recent history to appreciate the dangers of a variable rate product with no limitations on the amount the interest rate can increase from year to year. For example, if you take the median amount of credit outstanding on a home equity loan, $25,000, and assume an index of prime plus 1.5 percent, then you can see that the consumer would expect to be paying about $2,500 in interest over the next year. While the consumer might well factor in some increase in interest rates, how many consumers would factor in the doubling of the prime that occurred only 6 years ago which would double the interest payments on a $25,000 loan to over $5,000 in 1 year. How many people in fact could afford that difference?

Given that the consumer would lose his or her home in such an event, it is incumbent upon us I believe to make sure that the consumer knows what he or she is getting into and to make sure that lenders do not overreach. We already have three efforts underway to assure consumers more disclosure at key decision points. Congressmen Price and Schumer have introduced bills to accomplish that purpose and the Federal Reserve Board is considering revising its regulations to accomplish a similar end.

These are important steps and may well be all that is needed. However, I think it's important to examine whether there are some lender practices that serve no socially useful purpose and should simply be prohibited. One such provision that raises that concern for this Senator is the clause that a number of lenders include that would permit them to change any and all terms unilaterally. Such a provision, in my mind, is totally one-sided and leaves the borrower at the lender's mercy.

In addition, Congressman Schumer's bill and several of the witnesses raise other questions about some of the substantive terms such as the absence of internal caps, promotional or teaser rates, interest-only payments, and balloons, the use of private indexes, and the right to foreclose.

I will be interested in exploring whether the legislation should address any or all of these terms. I'm not going to hold up our witnesses any longer. We have our distinguished colleague from North Carolina, Senator Terry Sanford, who is with us this morning for the purposes of making some comments as well as introducing his Congressman, who I had the pleasure—of both those gentlemen last evening—in discussing every issue but home equity loans I think over dinner.

So, Terry, I'm delighted to welcome you here to the committee this morning and, of course, I'm honored to have my chairman, Bill Proxmire, and Senator Wirth here as well, and we will quickly get to you. I know both of you have votes going on in the House and so I don't want to delay you unnecessarily.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Mr. Chairman, I thank you for holding these hearings on a subject that is of great concern and has received much media attention. This attention has certainly pointed up the necessity for protecting the consumers in this newly developed kind of a loan. No doubt home equity loans developed to a great extent because of the tax laws. Certainly their tax advantages have been widely advertised and promoted.

But I'm especially glad to have the chance to introduce to this committee a Member of the House of Representatives that I think is the kind of person that ought to be here in the Congress. He's been a friend of mine since he came to Duke University in 1973 to our political science department, and I might say that he had a very distinguished record prior to his election last year. He graduated from the University of North Carolina where he was a Moorehead Scholar, which is just about as high an honor as a young high school graduate can receive. Then he got his Bachelor of Divinity Degree and Ph.D. in political science from Yale University.

I might say we hired him as a political scientist. I never have really tested him on his divinity.

Senator Dodd. We're going to test that this morning. [Laughter.]

Senator Sanford. But in addition to being a splendid professor and a highly sought after teacher, he's been very active in producing scholarly works, including three books, one of particular interest right now—"Bringing Back The Parties." He also served as the staff director for Governor Hunt on the Hunt Commission on Presidential Nominations. Then, not satisfied just to be in the classroom, he became the director of the Democratic Party in North Carolina, then the chairman of the Democratic Party in North Carolina, and he's presently on the Democratic National Committee. So David has been an academic political scientist and also a practical political scientist. I know the citizens of North Carolina in the 4th District, which is the Research Triangle District, are very, very delighted that he's representing them here in Washington.

I also want to congratulate David for crafting a very excellent bill on home equity loans and I want to commend this bill and the ideas in it to my colleagues on their committee. The bill has an impressive list of bipartisan cosponsors and I like it especially because it represents a sound balance between disclosure and the protection of the consumer and a concern about unduly burdening banks with requirements that serve little purpose.

The banks, at least in North Carolina, tell me that they like this bill. It puts equity credit lines under the same Federal truth-in-lending guidelines as any other form of home mortgage. It bans certain forms of aggressive and misleading advertising and, of great importance, it insists that the consumer, many of whom are older people, are carefully informed that their home is at stake and can be foreclosed.

Given the growing popularity of home equity loans since the 1986 Tax Act, I think it's essential that we examine the need for safeguards and I commend you, Mr. Chairman, for holding these hearings and I thank you, Congressman Price, for being here.

Senator Dodd. Senator Proxmire, do you have an opening statement?

Senator Proxmire. No.

Senator Dodd. Senator Wirth?

Senator Wirth. No, Mr. Chairman.

Senator DODD. We will begin with you, Congressman Price, and go right to Congressman Schumer and we will reserve our questions until both of you have completed. Obviously, your testimony will be included in the record and you may proceed in any way you feel most comfortable.

STATEMENT OF CONGRESSMAN DAVID E. PRICE, U.S. HOUSE OF REPRESENTATIVES, FROM THE STATE OF NORTH CAROLINA

Representative PRICE. Thank you, Mr. Chairman, and thank you, Senator Sanford, for those kind words and for the subcommittee's welcome.

Senator Dodd and members of the subcommittee, I am grateful for the opportunity to appear before you today. I appreciate the interest your subcommittee has taken in this important area for consumers.

Home equity loans have become the latest financial craze. Much of the increasing popularity of these loans is due to the Tax Reform Act of 1986 which phased out the deductibility of interest on other consumer loans while leaving it in place for loans secured by one's home.

Banks have marketed this product heavily and I have brought four examples of these advertisements with me today. As you can see, each of these ads that I brought prominently displays one possible feature of these loans. In this case [indicating], a low interest rate; a discount on settlement fees; fixed monthly payments and in some cases interest-only payments; or no closing costs. So a consumer can be faced with a dazzling array of possible loan terms and conditions.

Unfortunately, however, under current law, the consumer may never be advised about the essential features of his or her home equity loan until it's time to sign the final agreement. Currently, under regulation Z requirements for open-ended credit, a comprehensive set of disclosures is only provided when credit is extended to the borrower. While these disclosures are necessary, they fail to give consumers key information at a time when it would be useful for comparing products of different institutions and deciding whether home equity loans would be the best financial option for them. Furthermore, a consumer may have already paid a nonrefundable fee and may never have seen important provisions of the loan prior to the extension of credit.

KEY PROVISIONS OF H.R. 3011

H.R. 3011 will help the consumer place these loan options in perspective. Regardless of what first attracted a consumer to home equity loans, H.R. 3011 will require that at the time of application a consumer will be given a series of key disclosures which will enable him or her to make a sound judgment about these loans.

Under H.R. 3011, therefore, disclosures about the interest rates and fees are given to consumers early on in the loan process. The bill also requires a financial institution to disclose whether its loan product has annual and lifetime caps on interest rates and, if there are caps, what the limits are, and also requires the presentation of an example which will let consumers see the potential impact of a rise in interest rates on their monthly payments. These early disclosures will also include a series of statements about features of the loans, like interest-only payments, if applicable, which may have drawbacks for certain consumers. Finally, the Federal Reserve will be required to develop a pamphlet which will be furnished to prospective borrowers. This pamphlet will give detailed information about home equity loans and discuss their relative advantages and disadvantages.

My concern with the timing of these disclosures is consistent with the Federal Reserve Board's proposed changes to regulation Z [Truth-in-Lending] regarding closed-end adjustable rate mortgages. The most significant change proposed to regulation Z would be the requirement that more information be given to consumers about ARM's at the time of application.

Now home equity loans are specifically excluded from these changes because they give an open line of credit whereas ARM's are considered to be a closed-end line of credit. Open end credit allows consumers to borrow and repay against their home equity line as needed rather than receiving a fixed lump sum at one point in time. However, this difference between ARM's and home equity loans should not obscure the necessity, in both cases, of informing consumers early on about the risk to their homes and the terms and conditions of the loan.

H.R. 3011 also recognizes that there have been some problems in the advertising of home equity loans, and I have included some provisions to remedy them. For example, this ad of the American Security Bank, which features a monthly payment amount, would currently not be required under regulation Z to reveal such terms of the loan as the annual percentage rate, which is now incompletely disclosed in this particular ad in the fine print. My bill will ensure that any periodic payment amount mentioned in an ad requires additional disclosures on the part of the lender.

The bill also outlaws misleading terms like "free money" and requires any advertisement which mentions the tax deductibility of the loan to also clearly and conspicuously state that such interest expense may not be completely deductible in fact for all taxpayers.

H.R. 3011 basically embodies a disclosure approach. I believe that the additional statutory restrictions which some wish to impose on this particular product might well have an adverse effect on consumers. For example, some have proposed that any teaser rate offered by an institution be required to be in place for a year. If passed, this provision might cause the termination of an offering of this type. I would prefer an approach which allows the consumer to have the benefit of a teaser rate for a certain period of time, at the same time placing that rate in proper perspective relative to long-term interest charges. I believe my bill would achieve that result.

Now this is not to say that I am unalterably opposed to any restrictions that go beyond the terms of H.R. 3011. Some areas are worthy of further discussion. For example, Senator Dodd has already mentioned the clause in many home equity contracts which permits a unilateral change in terms by the lending institution. But in general I am wary of imposing restrictions on home equity loans that we do not impose on comparable products and that would place these loans at a competitive disadvantage.

I want to mention one particular area where I believe no change should take place. I am opposed to any change which would mandate restrictive requirements like a specific annual or lifetime cap on these loans.

Now Congress, of course, has recently dealt with one aspect of this problem. The Competitive Equality Banking Act of 1987 already requires a creditor to establish a lifetime cap on the interest rate of a home equity loan.

I believe we should require the full disclosure of this and any other caps, but that we should not mandate any particular percentage figure. I am concerned about the impact of a cap on other customers of the banks, particularly low and moderate income consumers.

Home equity loans are mainly a middle class and upper class phenomena.

If home equity loans were capped as "protection" for middle and upper income borrowers, institutions could be forced to shift costs to other consumers, many of them low-income borrowers who need a car loan or similar financial assistance. Variable rate loans represent a contract between the bank and the customer. The customer receives lower rates than on a comparable fixed rate loan in exchange for taking on the risk of possibly higher rates in the future. My bill is designed to ensure that a consumer is fully informed about the risk and benefits of these loans, but will not encourage cost-shifting by restricting home equity loans more than other loan instruments.

Mr. Chairman, I believe there is ample proof that my colleagues on the House Banking Committee and in the House agree with the approach embodied in H.R. 3011. Currently, we have 61 cosponsors, including 25 members of the House Banking Committee. It is a bipartisan group of cosponsors, and I believe we have an excellent chance to pass a bill of real benefit to the consumer.

In formulating this bill I have discussed and considered proposals from both consumer and industry groups. This legislation has grown out of these discussions, and the result is a bill stronger for consumers and more workable for financial institutions. I look forward to working with subcommittee members as they proceed with further consideration of home equity loans and the need for legislative action in this area.

Thank you, and I would be happy to respond to your questions.

Senator **Dodd**. Thank you very much, Congressman Price.

Congressman Schumer, welcome.

STATEMENT OF CONGRESSMAN CHARLES E. SCHUMER, U.S. HOUSE OF REPRESENTATIVES, FROM THE STATE OF NEW YORK

Representative **Schumer**. Thank you, Senator. I want to begin this morning by thanking you and the committee for inviting me to testify. Home equity lines of credit present new challenges and some problems to consumers. So it should not be a surprise that you, Senator Dodd, are at the forefront of this issue.

I also want to thank my colleague on the House Banking Committee, Congressman Dave Price, who has helped enormously in bringing attention to the issue of home equity loans and the problems they present to consumers.

Mr. Chairman, when the stock market fell recently there was much instant analysis of what went wrong. Although there is not one cause of the loss of confidence that triggered the decline, many, including myself, believe that the dramatic increase in consumer debt had a lot to do with it.

Now, at a time when consumer debt has reached all-time high levels, home equity loans are the hottest banking product in years. Banks have been pushing them hard and consumers are lining up to apply for them.

But home equity loans can be like a loaded pistol. Consumers need to be aware or they can blow up in the consumer's face.

POTENTIAL PITFALLS

Home equity loans have several potential pitfalls if a consumer is not completely aware of what he or she is buying. Some of the pitfalls are present even when the consumer is completely aware. So I am glad the Senate is taking an interest in the issue.

The biggest problem is what I call "Rate Rise Surprise." Too few consumers realize that most home equity loans carry a variable rate of interest. Almost all variable rate home equity loans have no ceiling on how high the interest rates can go. This can be an equation for disaster for homeowners.

Interest rates are relatively low today. But if we go through a period of high interest rates like we saw in the late 1970's and early 1980's, the increase in rates can put many homeowners over the brink. But unlike swings in the stock market, the losses are not cash and paper but bricks and mortar—your home.

Some banks are making the home equity loan even more mysterious and dangerous to the consumers with the way they determine their variable interest rate. While most banks tie their interest rates to some real cost of money like the prime rate, there are some who rely on nothing but the whim of the board of directors of the bank to set the interest rate.

For example, the National Community Bank of New Jersey offers a home equity loan that has a variable interest rate but no publicly available index. The index is determined by the board of directors of the bank. Since National Community has no rate cap, the interest rate could rise out of sight even if the cost of money has not increased. You could be paying 8 percent and the next month, because of a meeting of the board of directors, you could be paying 20 percent.

The problem of "Rate Rise Surprise" is made even worse by advertisements that tout super low "teaser" rates that only apply for the first few months of the loan.

Another potential pitfall of the home equity loan is what I call "Balloon Crunch." Many banks offer temptingly low interest rates and payment schedules at the beginning of the loan only to slam the consumer with one lump sum payment in a later year.

American Security Bank of Washington and Manufacturer's Hanover Trust of New York offer home equity loans that allow for interest-only payments on the loan for the first 10 years of the

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loan. After 10 years, the entire amount of the loan is due in one lump sum payment.

In a particularly bad case, The Bank of Contra Costa in San Francisco offers a home equity loan that allows the consumer to pay only 1.5 percent of the balance for 5 years and then requires a balloon payment of the entire amount of the loan. And the minimum line of credit they extend is $25,000. So the final payment could sink almost any family.

Perhaps the most troubling trend in the marketing of home equity loans is that the consumer is rarely given the whole picture in advertisements and solicitations for the product.

Although many ads for home equity loans tout the supposed tax deductibility of the loans and they scream about the loans being "free money", there are often key facts that the banks don't advertise.

Citizens Savings Bank here in Washington has run ads that go to great lengths to advertise that its interest rate is fixed for 3 years. What the ad does not say is that after 15 years the loan results in a balloon payment.

The Bank of the West in California loves to advertise all the great things that a home equity loan can provide money for, but it makes no mention of its interest rate, its index, or its big balloon payment.

THE HOME EQUITY LOAN DISCLOSURE ACT OF 1987

To deal with some of the problems with home equity loans, I have introduced H.R. 3468, The Home Equity Loan Disclosure Act of 1987.

Disclosure is in the title of the bill because I feel that disclosure is the most important element of the bill. H.R. 3468 would mandate clear disclosure of the rate formula and index, any fees or points as well as a warning about the risky nature of home equity loans in advertisements for the loan. Clear disclosure of these items in ads will allow potential borrowers to comparison shop much more easily and it will also put a chill on the many deceptive ads we have seen.

H.R. 3468 also provides for disclosure at the time of application of some other key facts about the loan. For example, the bill would require that the lender clearly lay out for the consumer what the schedule of repayment would look like using historic levels of interest rates.

The bill also addresses the dreaded—well, maybe not dreaded—"Rate Rise Surprise" by limiting the increase in interest rates to 2 percent per year. The bill does not have a life time cap, which I would oppose, but a 2 percent a year rise is consistent with what Fannie Mae has done for variable rate mortgages in the past.

If rates do shoot up, the home equity borrower will be allowed to climb up the interest rate ladder more gradually.

My bill would also make it illegal for any bank to be in control of the index that will be used to calculate the changes in the interest rate. If the interest rate on a home equity loan is going to be variable, then it should be a publicly available index, not some arbitrary number that is changed at the whim of the bank.

To further protect the borrower, H.R. 3468 would make interest-only payments on home equity loans illegal. Interest-only payments—ones that retire no principal—have the advantage of allowing for very low monthly payments. The problem is, that if a percentage of the principal is not paid off as the loan matures, the payments in the closing years can be devastating and a family can lose its home. Home equity loans should be repaid in a way that allows them to be fully paid off over a fixed term.

H.R. 3468 would also add a provision that would outlaw what I call "Surprise Balloon Payments." Surprise balloon payments occur when a lender decides that they want to close out a home equity loan it calls in the outstanding balance. Often lenders reserve this right in the contract. My bill would not allow such a right to be reserved to the lender. The bill makes it illegal to call in a loan before it has matured unless the borrower has been delinquent.

H.R. 3468 also keeps lenders honest by disallowing such deceptive terms like "free money" and "loan at prime" from being used in advertisements. The bill also makes the "teaser rate" less of a tease by locking in the advertised rate for 1 year.

In conclusion, there is a feeling in Congress that consumers are being led into the home equity loan market without enough information and protection. And there is agreement that the advertising of this hot new banking product has often been deceptive and sometimes outrageous.

When considering this issue we need to keep in mind how high the stakes are. A person who makes a mistake with a home equity loan puts nothing less than his or her home at risk. For this reason, I think we should give extra careful scrutiny to home equity loans. And that is why the actions of this subcommittee and you, Mr. Chairman, are so important.

Thank you again for the opportunity to testify before you this morning.

Senator Dodd. I thank both of you very much for being here. As I said at the outset, I think there's a tremendous service being provided by trying to address some problems before they become serious problems down the road. As you point out, the life of these loans has not been a problem since they are relatively new and the activity is new. So we're guessing a bit as to what may happen in the years ahead, but I think by beginning to address the problem now and particularly with regard to some of the issues of disclosure—I think there seems to be some commonality between the Fed and both bills. The issue really is whether or not we ought to go a bit further, as you have suggested, Congressman Schumer, or just limit it to disclosure at this point and see whether or not the marketplace will take care of some of the other issues.

Congressman Price, I think all of us recognize that the kinds of people economically who are taking advantage of the home equity loans are middle or upper middle income people. This is not something that is being used by people who have less economic resources.

WHY NOT HAVE A CAP?

That being the case, what is the problem with having a cap, since the people who are using it, who are at that lower-income level, seem to me to be best able to protect them, number one; number two, with first mortgages, of course, there are caps, both on the annual rates and the overall life of the mortgage. I don't know of a system that doesn't have a cap of one kind or another. Since we are talking about the collateral here being the home and the danger and all of that, why not have a cap here? Since there is a precedent for it, what would be the reason really for not doing it?

Representative PRICE. Well, you're correct in your assumption about the kind of people who by and large take out home equity loans. There is a study by the University of Michigan Survey Research Center which conclusively shows that home equity borrowers have a higher median income and education than homeowners generally.

We are looking here at one specific product and the question is, Should we impose restrictions—specifically caps—on this product that would put it at some competitive disadvantage and might encourage the banks to shift costs to consumers of other products?

Now the Competitive Equality Act just passed, of course, does require home equity loans, like other mortgages, to have a cap. It simply doesn't specify what that cap is.

My bill would require the full disclosure of that cap and of any other caps. I think that the imposition of a specific percentage figure would be a mistake, simply because it would single out this product and impose restrictions here that we don't impose on other products, and also because it might well encourage the bank to shift costs toward other customers of the bank, customers who in many cases would be lower and middle income customers, customers for car loans and that sort of product.

It seems to me that we ought not to load this home equity product down with restrictions that don't apply across the board.

Senator DODD. Would it be fair for me to conclude that what you are saying is you would discourage—or we ought to discourage low income people from seeking home equity loans, given the potential volatility and of course their economic inability to meet what could be a potentially serious problem? Should we discourage those people in that economic category who are seeking home equity loans?

Representative PRICE. Well, I wouldn't make that as a categorical statement. I do think, though, that this is a risky product and that people with limited incomes should be especially wary of incurring these obligations, particularly since this is an open-end line of credit and it does put the home at risk.

I believe, though, that the way to protect these consumers and all consumers is through full and accurate disclosure.

Senator DODD. Well, we've done that. In fact, Congressman Schumer and I worked very closely on legislation dealing with credit cards where it's purely a disclosure bill in that case. There, in fact, was an issue I know you, Congressman Schumer, faced as well with the question of caps in the committee, and I tend to agree with you that we ought to try and stay away from caps wherever possible, but I was intrigued because of, as I say, first mortgages do have caps where the home is involved. We place a special significance on the home rather than the car or the appliance you buy to protect consumers against that possibility of losing their homes.

But, Congressman Schumer, we didn't regulate the cap on the first mortgage. The marketplace did. Why not let the marketplace regulate it in this area, too?

Representative SCHUMER. Well, I don't advocate an overall cap. In other words, I agree with you that we shouldn't have a cap on how high the rate could rise. If interest rates go up to 18 percent, home equity loans obviously can't stay stuck at 15 percent or we would have a banking collapse in this country.

What I do advocate, though, is a limited rise per year so that a consumer is not just completely thrown out of whack by a quick rise. So what I propose—really we took the page from Fannie Mae's book—when the adjustable rate mortgages, which also can float up and down, came out, initially there were no changes and they found one of the great problems was that people would lose their homes because rates went up from 7 percent to 12 percent in 1 year and they couldn't make it.

What I'm saying is that there ought to be a limit on how much it could rise each year, but eventually it could float up as high as the market would be.

Now that would mean, of course, that the initial loan might cost a little more, but I think that's a risk well worth taking. I disagree with my good colleague, Congressman Price, that these loans are the same as a personal loan or as any other loan. I think, as you have indicated, there's something special about a loan where your home is at stake.

Senator DODD. Let me ask you both this, and this isn't normally the way we do things but you're going to have to leave and won't hear Martha Seger testify. I don't know if you've had a chance to look at her testimony. And she might be interested in your comments on this as well.

Beginning at the bottom of page 8 of her testimony, she says, "The Board, however, generally opposes the imposition of substantive restrictions"—she's now talking about both your bills and offering some observations on them—they oppose the imposition of substantive restrictions "on a particular loan product absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices. At this time, we are unaware of any evidence that such practices exist."

What's your comment on that conclusion?

Representative SCHUMER. Well, I guess I'd have to know what practices the "such" refers to. It seems to me that my testimony and Congressman Price's and others' show that there are many situations where rates could get out of hand, that there aren t those kind of restrictions now. That bank in New Jersey that I mentioned, you could have something go from 6 percent up to 20 percent in a month.

Senator DODD. Well, she's talking about rate floors, interest-only payments which you raised in your testimony, prohibiting credit extensions in excess of 75 percent of a dwelling's fair market value.

Those are three and there may be others, but those three come in the paragraph before.

Representative SCHUMER. There are certainly banks—I can't speak to the third one, the 75 percent, because I don't have any of those handy in my testimony—but on the other two, there are banks that are running into problems—running into problems is stating it too strongly—that exhibit those practices and that's why we put them in the bill.

This wasn't prophylactic. There were clearly banks doing every one of the things that this bill would prohibit.

Senator DODD. Congressman Price?

Representative PRICE. Senator, let me just say that a number of these features that we've discussed might very well be attractive in the marketplace and might well be desirable for consumers. For example, I can imagine many lending institutions offering an annual cap as a feature of their product.

The question is whether we should require any particular figure. We are requiring disclosure. Presumably, that would encourage these features to be offered.

As I indicated in my statement, however, there are some problematic areas that would bear examination in terms of substantive regulation—the question of a unilateral change in terms, for instance.

Senator DODD. I was just going to get to that with you. What's your thought about that being flatly prohibited?

Representative PRICE. Well, there may be some circumstances under which a change in terms would be justified, but clearly that ought to be limited. For example, Merrill Lynch has adopted an interesting approach to that problem. They have written into their home equity contracts a provision whereby a consumer would be able to draw down the account under the old terms in exchange for not using the account again if the bank proposed to change the terms of the loan.

I think that kind of change in terms would be undertaken by a lending institution only in extreme circumstances. It would be highly unlikely. On the other hand, there might be extreme circumstances that justified that and then the consumer ought to have certain rights to draw down the loan under the old terms. I think some kind of regulation along that line would be justified.

I think some reasonable limit on the right to call in a loan is appropriate, and there may be other areas where we might want to consider some restrictions. On the other hand, when you get into the area of teaser rates or interest-only payments or annual caps, it's not clear to me that we ought to specify in law a great many substantive restrictions.

Senator DODD. What about the public indexing which is the idea that the board of directors, as you have in one of the cases that Chuck has pointed out, as opposed to using a public index, T-bills, whatever—what about that? Do you think we ought to just flatly prohibit that, prohibit a board from just determining on its own what their index would be and requiring that there be some public indexing, for instance?

Representative PRICE. It's obviously undesirable for a bank to be able to arbitarily alter the interest rate on this product and only this product. I don't see evidence that banks are doing that. I am not sympathetic to the idea of requiring a particular index. It might be appropriate to forbid the use of an index that applies only to this single product. But I don't think it's very likely that banks are going to adjust or manipulate their prime rate, which of course serves a number of functions for the bank, simply to sock it to home equity borrowers. I don't see evidence that that's occurring and I don't think any particular index ought to be required in law.

Senator DODD. My time is up. Do you want to comment on that?

Representative SCHUMER. Just one other point, Senator, which is, I hasten to add I think the majority of banks will approach these loans in good faith. I mean, they are in the community. They don't want to get a bad reputation or anything else. But there are going to be situations, as we found in banking laws throughout the past, where certain institutions do try to take advantage and that's who really we're looking at here, not at every bank under the sun.

Senator DODD. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Gentlemen, I want to congratulate both of you on two excellent statements. I'm not surprised. You are two real stars from the House and you have demonstrated your ability and intelligence many times and this morning is one of them.

Congressman Price, I notice that you say on page 3 that one of the reasons why you oppose a cap or oppose any other limitation of the kind that Congressman Schumer calls for in his bill is because the borrowers by and large, are high income people. You say, "Data from the University of Michigan's Survey Research Center have shown that home equity borrowers have a higher median income and education than home owners generally."

How much higher is that?

Representative PRICE. I don't have that specific figure but I can get it for you.

Senator PROXMIRE. I think that's a very good point because it seems to me that we have a very serious debt problem in this country. It's not only a Federal debt problem. We've concentrated 99 percent of our attention on the Federal debt, but the household debt and the business debt each are far bigger than the Federal debt, and in aggregate they have an equal effect on the economy, on our future and make us very vulnerable to recession.

So I think what we need is a Ben Franklin, if not an Ebeneezer Scrooge, position vis-a-vis debt, and so I commend you on what you have here.

Representative PRICE. Mr. Chairman, I'm told that that figure is $6,000. The average home equity borrower has an income $6,000 above the median.

Senator PROXMIRE. $6,000 above the median.

Representative PRICE. That's considerably above the national median income.

Senator PROXMIRE. Almost 50 percent above the median.

Well, Mr. Schumer, you I'm happy to say also have no cap and you say it would only be 2 percent a year, is that right?

Representative SCHUMER. Right.

Senator PROXMIRE. And again, that seems not only to encourage more borrowing but would also encourage more borrowing by people who need it less because they are more affluent.

How do you justify that?

Representative SCHUMER. Well, I think it comes out different ends in the beginning. In other words, I think the initial loan would probably be a little higher rate if the bank knew that it would be caught if there was a rapid rate rise and couldn't raise to the amount immediately. The initial rate they would offer would be higher, so it might actually foster what you have talked about, too much consumer debt—reducing some of it. And I agree with you. I think that this deficit—we have a Federal Government deficit and we have to reduce it, but the whole country is in debt and the Federal debt is only a percentage of it and if we reduce the deficit to a certain amount we're going to have a lot of other problems we have to deal with to straighten out this economy.

But getting back to the subject at hand, I think there's a danger on the other side and that's why I proposed the 2 percent. If you have a large amount of foreclosures because people cannot afford to pay the high rates, if rates should rise very rapidly, the damage to the economy would be far greater than the damage from not imposing this kind of cap—damage from allowing the rates to rise—and I think we have to be careful in this kind of brave new world we're in.

Senator PROXMIRE. Why wouldn't that have a desirable effect on the economy if the home equity loans were in the same position as all other loans? Why wouldn't it be desirable? Supposing you went from a 10-percent level to a 15-percent level in 1 year. What that would mean is that some people would pay off their debt. It would discourage them from staying as much in debt as they are. These are affluent people. They're the kind of people who should be paying off their debt. What would be wrong with that?

Representative SCHUMER. When Fannie Mae initially started issuing adjustable rate mortgages, they found that when the rates rose very rapidly there was a very high percentage or a very uncomfortably high percentage of homes being foreclosed which hurts the economy I think in a lot of ways and it would certainly slow down debt when 5 percent of all homes are foreclosed in a particular area. But it's sort of a scorched earth policy.

Senator PROXMIRE. But, Chuck, you don't show any data at all that there's any abuse now and looking at it from the standpoint of the lender we ought to consider that.

Representative SCHUMER. Sure.

Senator PROXMIRE. The lender is in the position where—we could have a very sharp and sudden increase in interest rates and suffer the same problem for S&L's and banks as we've had recently they borrow short term and lend long term, and they would be hurt badly.

Senator DODD. What you could have is that the borrower could call a line of credit and say he wants all the money. He could be making money off that money—actually if the lender is held to a cap—he could actually be using it and it's a pretty good money-making vehicle.

Representative SCHUMER. Or some investment banker will sell them into a secondary market.

Senator DODD. The first mortgage of course you get the money all at once and you're paying interest on the lump sum you received, whereas this one you are drawing down on a line of credit, so it could become a money-maker.

Senator PROXMIRE. That's a very good point made by the chairman. It's on his time, too. [Laughter.]

Representative SCHUMER. Well, I think the points are well taken. I think you have to decide which scenario is more damaging and I go by the experience in 1982 and 1981 that the scenario where these variable rates rose very rapidly. We want to help lenders, there's no doubt. I think a lot of prudent lenders would be for this kind of policy and might institute it on their own, but as always, we're regulating the more imprudent of the lenders.

Senator PROXMIRE. But Mr. Price's position I take it is more in step with what the Federal Reserve Board Governor Seger will advocate this morning?

Representative SCHUMER. I believe the Federal Reserve Board's position is for no regulations at all beyond disclosure, and I believe there ought to be some.

Senator PROXMIRE. In general, that's been the policy that we have followed more or less. The truth-in-lending and other consumer legislation has been primarily based on disclosure rather than on dictated caps.

Representative SCHUMER. Well, that's true, although as Senator Dodd indicated, in the area of mortgages we have taken certain steps beyond that.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator DODD. Thank you.

Terry, do you have some questions?

Senator SANFORD. I know that both our witnesses are in a hurry to get back to the House to a hearing taking place there.

FAILURE TO CLOSE LOOPHOLE IN TAX LAW

Let me ask this question. Do we not have this problem because we failed to close a loophole in our tax laws that we ought to have closed in keeping open the loophole of an interest deduction on home mortgages? Is this not just an inadvertent slippage? Is this a good public tax policy to have this kind of interest remain deductible?

Representative PRICE. Senator, my bill does not address the tax question. I'm concerned with another sort of "loophole," in disclosures. What I'm trying to do in my bill is essentially bring the treatment of these products into line with the proposed regulations for other adjustable rate mortgages proposed by the Fed. I'm not proposing to do a great deal more or a great deal less. I simply want to bring those disclosure requirements into line.

As Senator Dodd mentioned earlier, we have done some good work on credit cards, but there are certain shortcomings in those credit card regulations and certain ways in which home equity loans are quite different from credit cards in the kind of risk that they pose to the borrower.

We're making substantial changes in the requirements that now apply to credit cards. In my bill, we would be requiring at the time of application, before obligations are incurred, a series of key disclosures—annual and lifetime caps, an example of the effect of a change of rates on periodic payments, a statement regarding the risk to the home, and then, if applicable, the creditor's right to change the terms; if applicable, the result of interest-only payments; and then a required pamphlet from the Fed. All that is new, and all that goes beyond present law that applies to open-end lines of credit generally.

I think that's appropriate because these are, after all, a special kind of second mortgage. Then, of course, the advertising requirements also beef up the regulations, instituting a series of new "trigger" terms. If you mention periodic payments, you're going to have to give full disclosure of the terms. If you mention tax deductibility, you're going to have to tell the whole story.

It seems to me that we are moving considerably beyond existing law and existing regulation, but we are doing so in a way that does not inordinately burden these products relative to other products.

Representative **Schumer**. If I might, Senator, I think on the question you asked you're right. I think this was a loophole. I would be more comfortable—I mean, a home equity loan to fix up your own home, refurbish it or put on whatever you want, beautiful aluminum siding or something, is a different issue. But a home equity loan to go on a vacation or just buy other things, I don't think those should be tax deductible in fact and I think that was a mistake in the tax law and, getting back to what Senator Proxmire said, encourages the kind of borrowing the tax law was trying to say shouldn't get at least a tax advantage.

Senator **Sanford**. Maybe we ought to send a message over to the White House.

Representative **Schumer**. It would be nice if they would hear one.

Senator **Sanford**. The use of variable rates and those types of arrangements raised one problem that I wasn't aware of: Provisions apparently used by some lenders allowing them to make unilateral changes. Is there any precedent for that in any other kind of lending instrument?

Representative **Schumer**. I am really not aware of them, but I think that goes to the nature of how open-ended these loans are. They are a different animal.

Senator **Sanford**. But that in itself strikes me as being something that certainly should be prohibited in any kind of a lending agency where obviously one party has the advantage over the other.

Representative **Schumer**. Sure.

Senator **Sanford**. There are a great many other interesting things that you have brought up and certainly I'm grateful to both of you for thinking and working on problems raised by home equity loans. We want to do our part of it over here. I don't have any other questions except to say thank you both.

TEASER RATE

Senator **Dodd**. Let me just bring up one more, Chuck, because you raised it as such an important one—the teaser rates. David, you raised it as well in some of those advertisements, those monthly rates are pretty low that you have.

If you have a requirement that your teaser rate has to be there for a year, it leads you to two conclusions. One, you eliminate the teaser rates, which can be a disadvantage to consumers; or two, you raise the cost of the long-term rate, which is also sort of a disadvantage.

Why not just full disclosure of the rate, what the loan rate is going to be?

Representative **Schumer**. I guess I disagree. I think teaser rates really aren't an advantage to the consumer. It's sort of the worm on the hook and if you think the hook shouldn't be bitten by the fish, then you don't want to have a nice big juicy worm out there. So I'm not so sure they really do—I can't think of a policy reason—there might be certain circumstances where a consumer is getting a new job a year from now or comes into an inheritance or whatever else, but those are so few and far between that I think that most of the time teaser rates are often intended to line the fish on the hook and don't really help the consumer at all.

So at least if you're going to do it, make sure that the worm is tasty. Make it for a year, you know, none of these scrawny little worms on the dreaded hook.

TAX ISSUE

Senator **Dodd**. I don't know if there are any surveys done on this thing and, David, you mentioned earlier, kind of a profile of the borrower, but people who have talked about this—the reason people are doing it, they obviously want to do something. What is the advantage, is it one of the few tax breaks left?

Representative **Schumer**. You got it. That's right.

Senator **Dodd**. So it's really the tax issue. It's the income earner that itemizes. The low income earner doesn't itemize and this isn't worth anything to him on that basis. So it's the tax advantage it seems to me that is the real attraction, as opposed to teaser rates. That, to me, is where the people are moving into this area because it's for people who fall into that middle category who don't have the kind of availability of breaks and this is one that can really reduce their tax liability.

I suspect if you did a survey, in addition to wanting to put the new room on or do whatever else, while that might have been there, but the fact that you were going to be able to deduct virtually 100 percent of those payments if it's just interest only is the real attraction, if you were in any doubt at all. Do you agree?

Representative **Schumer**. I do.

Representative **Price**. Yes, Senator. I think possibly one disagreement between Mr. Schumer and myself is in our assumption about the attractiveness of this product. I think for many consumers it's a quite attractive product and I think the consumers need to know exactly what they are getting into, but I don't choose to see every advertisement as some kind of nefarious scheme to bait the consumer. I think what we need to make sure of is that advertisements are straightforward and that full disclosures are made at the time of application. But I do not assume that we ought to explicitly discourage the use of this product.

Teaser rates may or may not be advantageous. I think the teaser rate, if it's offered, ought to be accompanied by full disclosure of the whole story in terms of interest charges. I can't see, though, outlawing teaser rates or saying that they have to extend over a certain period of time. It seems to me we want to make sure they are straightforwardly presented, but beyond that the consumer can make his own rational decision.

Senator DODD. Well, thank you both for excellent testimony. As always, it is very, very helpful.

Representative SCHUMER. Senator, I'd like to thank you for these lovely U.S. Senate coasters that have been provided.

Senator DODD. Typically when you come here you like to steal things from the Senate, so we'd like you to leave it here. There are other witnesses that are going to be here this morning and they're going to want to use that.

Representative SCHUMER. They each have their own right over there. [Laughter.]

But I would say, Senator, that this is the best thing I've stolen from the Senate so far. [Laughter.]

Representative PRICE. Thank you, Mr. Chairman.

Senator DODD. Thank you both very, very much.

Martha Seger, we welcome you and appreciate you being here this morning. I hope you didn't mind me quoting from your testimony. It's not really fair to you, but I thought they wouldn't be here and I was curious as to how they would respond to that particular conclusion you had reached.

You've been here and you know how we proceed. We have your testimony and if you'd care to just offer a synopsis or however you would be most comfortable, you may proceed.

STATEMENT OF MARTHA R. SEGER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Ms. SEGER. Thank you very much. I am glad to be here and I do have just a short statement to read that is a synopsis of the one we distributed to you.

Senator DODD. Fine.

HOME EQUITY LINES OF CREDIT

Ms. SEGER. I, too, want to discuss home equity lines of credit, a subject that has received increased attention lately. There has been a substantial growth in this type of credit since 1984, with outstanding balances totaling approximately $40 billion at the end of 1986. We believe that the total may now be as high as $70 billion and could reach $80 billion by the end of this year.

Recently, the Board and other bank regulatory agencies changed the reporting requirements for credit secured by real estate to provide more complete and accurate information on household borrowing through home equity lines of credit. This change should provide more accurate information for an important segment of the market, and enable us to better gauge the growth of this type of credit and the effect it is having on other consumer borrowing.

In addition, the Board has conducted consumer surveys this year to gather information that will allow us to better understand consumer usage of home equity lines of credit. These surveys, which were conducted last March and April, included 1,300 families, 930 of whom were homeowners. As of April 1987, 6 percent of the homeowners in that survey had established home equity lines of credit, and an additional 1 percent had applied for these credit lines. The surveys indicated that consumer awareness of home equity lines of credit is high, probably because of all the advertising that the two previous witnesses referred to. Eighty percent of all homeowners surveyed stated that they were aware of the existence of such credit plans, although a majority of the respondents who had not yet opened such credit accounts indicated no interest in establishing a home equity credit line in the future.

The surveys also revealed that those homeowners who had established home equity lines tended to have fairly high family incomes, more equity in their homes, and were younger and better educated than the average homeowner. In addition to these findings, the surveys showed that, relative to other types of credit lines, home equity accounts tended to be for larger amounts, with the median size of an account approximately $25,000. The most common reasons given for using home equity accounts were to pay off other debts and to finance home improvements. Forty-five percent of accountholders had no balances outstanding on their home equity lines, while the median amount outstanding for accountholders with unpaid balances was just under $15,000.

During the past year, Board staff has been considering the issue of home equity lending within the context of Truth-in-Lending disclosure requirements. The staff's analysis indicates that the current regulatory requirements for open-end credit may not adequately reflect the complexities that are present in most home equity programs. Specifically, the staff has focused on the content, timing, and format of the disclosures required under regulation Z as possible candidates for regulatory change. At this time, our staff is preparing a proposal that would amend regulation Z to address these issues and expects to present their recommendations to the Board within a few weeks. Although the review is still in process, and neither the staff nor the Board has made any firm decisions about what can and should be done, I would like to share with you some of the particular issues we have been considering.

Under current requirements, when a home equity plan is opened, a creditor need only give general disclosures about how the finance charge will be determined, what other charges will be imposed, the security interest being taken, and the consumer's billing rights. Creditors are not required to disclose certain items such as their right to unilaterally change the terms and conditions of the plan, or the possibility that a balloon payment may be required as part of the plan. It is conceivable that regulation Z could be amended to require disclosure of these features. There also may be a need to require more disclosures in home equity line advertisements. A question raised in this regard is whether disclosing a payment term in an advertisement should require disclosure of other material terms, such as the annual percentage rate or the fees to be charged under the plan. In considering any additional disclosure requirements, however, the Board is guided by the principle that disclosures should provide consumers with essential information, without overloading them with less important information or unnecessarily raising creditors' compliance costs.

TIMING OF DISCLOSURES

Another area we have identified as one to look into concerns the timing of disclosures. Regulation Z currently permits open-end credit disclosures to be given any time prior to the first transaction. In the case of home equity lines of credit, therefore, consumers may not receive disclosures about the terms and conditions of the plan until closing. Since many home equity credit plans involve large application fees and tend to be more complex than other types of open-end credit, an argument can be made for requiring disclosure of the fees, terms, and conditions of such plans at an earlier time in the credit process.

Finally, concern has been expressed that consumers may not fully understand the terms and conditions of the programs. Currently, regulation Z does not require any special format for open-end disclosures. As a result, in most cases, the disclosures given for these plans are not segregated from the contractual provisions or highlighted in any standard manner. We believe that consumers should be alerted to the most important terms and conditions of the plans for which they contract. To the extent that the current regulatory requirements fail to meet this goal, it might be necessary to require that disclosures about these plans be segregated from other information.

At this point, I would like to mention that at its meeting in October 1987, the Board's Consumer Advisory Council generally endorsed the idea of requiring additional disclosures for home equity lines in advertisements and in initial account disclosure statements. The Council also supported the idea of requiring creditors to provide disclosures for these loans at an earlier stage of the credit-granting process than is currently required. In addition, Council members saw the need to have these disclosures highlighted in a manner that would alert consumers to material information about the terms and conditions of these programs.

The subcommittee has asked that we comment on legislation concerning home equity lines that was introduced in the House. H.R. 3011, which was introduced by Congressman Price, who was just here, would amend the Truth-in-Lending Act to establish additional disclosure and advertising requirements for open-end credit plans secured by the consumer's dwelling.

The Board generally supports the approach taken in H.R. 3011 to require additional disclosures for home equity plans at an earlier stage of the credit-granting process. The Board also believes that material information about these plans should be presented in a manner that will alert consumers to the most important information about the cost of their credit transaction. To the extent that H.R. 3011 addresses these concerns about the content, timing, and format of disclosures given to consumers, the Board generally favors the bill's intent.

H.R. 3468, which was introduced by Congressman Schumer, would also amend the Truth-in-Lending Act to require additional disclosure and advertising requirements for home equity loans. Perhaps the most significant feature of H.R. 3468, however, is the fact that it would impose additional substantive requirements on home equity loans, such as prohibiting the establishment of rate floors and payment schedules that would permit interest-only payments, and prohibiting credit extensions in excess of 75 percent of a dwelling's fair market value.

To the extent that H.R. 3468 would require creditors to provide consumers with more information about the cost of a credit transaction, the Board would generally support this goal. The Board, however, generally opposes the imposition of substantive restrictions on a particular loan product absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices. At this time, we are unaware of any evidence that such practices exist.

Moreover, to the extent that imposing substantive restrictions could affect a creditor's ability to offer this type of loan product, consumers who might otherwise enjoy the advantages that such a product offers could be adversely affected. For example, H.R. 3468 would prohibit plans that allow interest-only payments, a feature that might be attractive to consumers who prefer the lower monthly payments offered by these plans and who fully understand that a balloon payment may result. In addition, the bill would prohibit rate floors for home equity loans with a variable-rate feature. Such a restriction could adversely affect a creditor's ability to offer a home equity product, since creditors have fixed operating costs that may necessitate their placing limits on the minimum rate that can be offered to consumers. Moreover, prohibiting creditors from setting rate floors may be ineffective since creditors may be obliged to seek alternative sources of revenue through increased fees and transaction charges, or through the imposition of higher maximum interest rates or greater interest rate margins. The Board, therefore, urges Congress not to adopt legislation that might unnecessarily restrict the offering of products that, in many cases, benefit consumers, particularly absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices.

I can assure you that the Federal Reserve Board shares the goal that consumers receive adequate information at a relevant stage of the credit-granting process when they contract for home equity loans. We believe that it is particularly important that consumers understand these programs since they may pose a greater risk because of their complexity, the large credit lines generally involved, and the possibility of losing one's home. On the other hand, I want to urge the Congress not to restrict the terms and conditions of home equity programs without sufficient evidence of a clear and unequivocal need for such action.

We look forward to working with you on this important subject and I would be glad to answer any questions you may have.

[The complete prepared statement of Martha R. Seger follows:]

Senator DODD. Thank you, Governor, very, very much.

We have been joined by my colleague from Rhode Island. I just have a few questions for you. First of all, before a question, we're very quick to be critical of the Fed in this committee and this Senator has been. I remember on dealing with the check hold bill I felt that the Fed had not moved quickly enough. But I want to tell you this morning that I think what you're doing in this area is terrific.

Ms. SEGER. Thank you.

Senator DODD. And we ought to be willing to say that here as well and not just raising our voice in opposition to failure to move on things. Your testimony is excellent. You raise some very good points.

ADEQUATE INFORMATION

I'm kind of curious—and maybe the question was answered by something I said earlier, but in your survey you show that about 9/10ths of the consumers who have taken home equity loans think they had all the information available to them, if I read your survey correctly.

Ms. SEGER. Right.

Senator DODD. And if that's the case, what one might quickly say is, well, what the devil are you doing posing regulations for if everyone is pretty much satisfied they've got the necessary information?

Do I gather what you're concerned about is not so much what is the case today but, given the explosion in this area and expanding consumer interest in it, that you see a strong potential for failure of consumers to have adequate information to make intelligent decisions about their own economic circumstances. Is that the reason or is there some other reason that I missed?

Ms. SEGER. I think that's exactly right. Also, we believe the markets work better when all consumers are well informed of the advantages and the features of all products. And so even if you're missing 10 percent, that's still 10 percent, and we really think disclosure of the key terms is important to push.

Senator DODD. Now the Fed in the past has been—and I'm sure you don't necessarily like to become pamphleteers—but with adjustable rate mortgages you have, if I'm correct, done pamphlets in the past on the ARM's and I'm wondering if you're thinking about doing something similar to that with regard to home equity loans.

Ms. SEGER. You're right, we did an ARM brochure with the Home Loan Bank Board that's gone over very well and we've been fiddling around with some material that might go into a brochure. But what we're seeing is that a number of other sources of excellent brochures are now available. For example, I just received one from the Federal Trade Commission and several private sector outfits either have prepared them or are preparing them. I know the AARP is doing something. American Express is working on one.

So I think before we would spend the kind of money to put out another one we might make sure that we've studied the existing publications. Maybe we would just recommend that we sort of get behind publicizing the availability of one or another of those.

Senator DODD. I think in the earlier testimony we examined the issue of the teaser rates, the annual caps and so forth. I presume you would sort of come out at where Congressman Price did in those areas. And I've even suggested some of the problems myself. I think by having a fixed teaser rate area that you might end up losing some of those lower rates which can be attractive. I mean, it does lure people but nonetheless it may be of help to people who truly need these programs.

I'd like to get, if I could, to two or three questions that I have a problem with, areas where I think Congressman Schumer has more of a case to make. That is, on the unilateral changing of the contract, if you will; on the use of public indices as a way of establishing those rates; and, of course, pulling out of the deal altogether just foreclosure.

PROHIBIT UNILATERAL CHANGING OF THE CONTRACT

Why not just prohibit some of those things? Why not just flatly say, look, unilateral changing of the contract we just flatly prohibit; you can't do that? If you do "x," "y" or "z" in conjunction with the borrower, then you can, but just the unilateral changing of the rules—why shouldn't we just flat out say that's wrong? Why don't we encourage public indices, giving a range of public indices you can use? I know there are many already used. But you cannot use your own internal board of directors. Again, I can't imagine anyone trying to compete in the marketplace, as Congressman Schumer pointed out, and expect to survive if they did that very long, but we write laws not for the many who obey them but for the few who don't.

So why not have that kind of a prohibition in our bill or a bill that might come forward?

Ms. SEGER. Well, to take that part first, when ARM's first became readily available there were five or six indices that were identified by the regulators as being publicly available. Those indices did tie one way or another into the cost of funds or to alternative instruments. ARM's disclosures often provide historical information on how all these indices had moved over the last 10 or 15 years. Most every issuer, I believe, has tied into one or another of those indices. Furthermore, under the regulators' joint ARM's disclosure package there is a commitment that the history will be disclosed, and lenders will continue to update the numbers on an annual basis.

Therefore, it's a convenience to the lender frankly to tie into one of the publicly available indices. And also it's helpful to the consumer to know that there are these and where you can find the information, et cetera.

So I guess I wouldn't have a problem, frankly, if we suggested that there be a package of possibilities for home equity loans and that one or another of those be specified by the lender very clearly. Although, I guess, too, I would hate to say we've got a pet index here we want to——

Senator DODD. I totally agree with you on that. I'm talking about a range. You pick and choose. Here are five or six or seven, what-

For Release on Delivery
10:00 A.M., EST
November 18, 1987

Statement by

Martha R. Seger

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

November 18, 1987

I appreciate the opportunity to appear before this subcommittee to discuss home equity lines of credit, a subject that has received increased attention lately. There has been a substantial growth in this type of credit since 1984, with outstanding balances totaling approximately $40 billion at the end of 1986. We believe that the total may now be as high as $70 billion and could reach $80 billion by year-end.

This rapid expansion in home equity lines is probably attributable to several factors. For example, the plans have provided consumers convenient access to credit at interest rates that are relatively low compared to other means of financing consumer spending. Tax laws phasing out the deductibility of interest for nonmortgage consumer debt have made home equity loans more desirable to tax conscious borrowers. In addition, competition among financial institutions to offer diverse financial services to their customers has resulted in vigorous marketing of home equity lines, often at low introductory interest rates and discounted fees.

Recently, the Board and other bank regulatory agencies changed the reporting requirements for credit secured by real estate to provide more complete and accurate information on household borrowing through home equity lines of credit. This change should provide more accurate information for an important segment of the market, and enable us to better gauge the growth of this type of credit and the effect it is having on other consumer borrowing.

In addition, the Board has conducted consumer surveys this year to gather information that will allow us to better understand consumer usage of home equity lines of credit. These surveys, which were conducted in March and April of this year, included 1300 families, 930 of whom were homeowners. As of April 1987, 6 percent of the homeowners surveyed had established home equity lines of credit, and an additional 1 percent had applied for these credit lines. The surveys indicated that consumer awareness of home equity lines of credit is high. Eighty percent of all the homeowners surveyed stated that they were aware of the existence of such credit plans, although a majority of the respondents who had not yet opened such credit accounts indicated no interest in establishing a home equity credit line in the future.

The surveys also revealed that those homeowners who had established home equity lines tended to have higher family incomes, more equity in their homes, and were younger and better educated than the average homeowner. In addition to these findings, the surveys showed that, relative to other types of credit lines, home equity accounts tended to be for larger amounts, with the median size of an account approximately $25,000. The most common reasons given for using home equity accounts were to pay off other debts and to finance home improvements. Forty-five percent of accountholders had no balances outstanding on their home equity lines, while the median

amount outstanding for accountholders with unpaid balances was $14,800.

During the past year, the Board has received inquiries from financial institutions, trade associations, consumer groups, and the Congress concerning home equity lines of credit. Much of the discussion has focused on the current disclosure requirements for these loans, and whether these requirements are adequate. In response to these inquiries, the Board has been reviewing its current regulatory requirements, with the goal of ensuring that consumers receive sufficient information prior to contracting for this type of credit.

Possible Regulatory Action

Since home equity programs are more complex than other types of open-end credit plans, and pose a greater risk to consumers if they fail to understand the terms and conditions of the plan, the Board, like the Congress, is concerned about whether the existing disclosure requirements under the Truth in Lending Act and Regulation Z ensure that consumers receive adequate information about these types of loans when they contract for a particular plan.

During the past year, Board staff has been considering the issue of home equity lending within the context of Truth in Lending disclosure requirements. The staff's analysis indicates that the current regulatory requirements for open-end credit may not adequately reflect the complexities that are present in most home equity programs. Specifically, the staff has focused on the content, timing, and format of the disclosures required under Regulation Z as possible candidates for regulatory change. At this time, our staff is preparing a proposal that would amend Regulation Z to address these issues and expects to present their recommendations to the Board within a few weeks. Although the review is still in process, and neither the staff nor the Board has made any firm decisions about what can and should be done, I would like to share with you some of the particular issues we have been considering.

Under current requirements, when a home equity plan is opened, a creditor need only give general disclosures about how the finance charge will be determined, what other charges will be imposed, the security interest being taken, and the consumer's billing rights. Creditors are not required to disclose certain items, such as their right to unilaterally change the terms and conditions of the plan, or the possibility that a balloon payment may be required as part of the plan. It is conceivable that Regulation Z could be amended to require disclosure of these features. There also may be a need to require more disclosures in home equity line advertisements. A question raised in this regard is whether disclosing a payment term in an advertisement should require disclosure of other material terms, such as the annual percentage rate or fees to be charged under the plan. In considering any additional disclosure requirements, however, the Board is guided by the principle that disclosures should provide consumers with essential information, without overloading them with less important information or unnecessarily raising creditors' compliance costs.

Another area we have identified as one to look into concerns the timing of disclosures. Regulation Z currently permits open-end credit disclosures to be given anytime prior to the first transaction. In the case of home equity lines of credit, therefore, consumers may not receive disclosures about the terms and conditions of the plan until closing. Since many home equity credit plans involve large application fees and tend to be more complex than other types of open-end credit, an argument can be made for requiring disclosure of the fees, terms, and conditions of such plans at an earlier time in the credit process.

Finally, concern has been expressed that consumers may not fully understand the terms and conditions of the programs. This concern may be due, in part, to the complexity of these plans and the fact that the underlying contracts could run several pages in length. Currently, Regulation Z does not require any special format for open-end disclosures. As a result, in most cases, the disclosures given for these plans are not segregated from the contractual provisions or highlighted in any standard manner. We believe that consumers should be alerted to the most important terms and conditions of the plans for which they contract. To the extent that the current regulatory requirements fail to meet this goal, it might be necessary to require that disclosures about these plans be segregated from other information.

At this point I would like to mention that at its meeting in October 1987, the Board's Consumer Advisory Council generally endorsed the idea of requiring additional disclosures for home equity lines in advertisements and in initial account disclosure statements. The Council also supported the idea of requiring creditors to provide disclosures for these loans at an earlier stage of the credit-granting process than is currently required. In addition, Council members saw the need to have these disclosures highlighted in a manner that would alert consumers to material information about the terms and conditions of these programs.

Legislative Proposals

The subcommittee has asked that we comment on legislation concerning home equity lines that was introduced in the House. H.R. 3011, which was introduced by Congressman Price, would amend the Truth in Lending Act to establish additional disclosure and advertising requirements for open-end credit plans secured by the consumer's dwelling. The bill would change the requirements concerning the content, timing, and format of the Truth in Lending disclosures that are now required for home equity lines of credit. Currently, the Truth in Lending Act and Regulation Z treat home equity lines of credit like other types

of open-end credit plans. As a result, creditors only are required to give the disclosures that I previously outlined. H.R. 3011 would require creditors to give more extensive and detailed disclosures about home equity loans. For example, it would require more disclosures concerning the annual percentage rate, including disclosure of the maximum amount that the rate could change in a one-year period, and, if no limit exists on annual rate increases, a statement to that effect. The bill would also add an example, based on a $10,000 amount outstanding, showing the payment terms under the plan, and would require creditors to disclose their ability to unilaterally change the terms and conditions of the plan. These disclosures, among others, would generally have to be given at the time of application, which is earlier than current requirements, and would have to be segregated from other disclosures, which is also a departure from current requirements. H.R. 3011 would also add a new advertising section to the Truth in Lending Act for home equity lines.

The Board generally supports the approach taken in H.R. 3011 to require additional disclosures for home equity plans at an earlier stage of the credit-granting process. The Board also believes that material information about these plans should be presented in a manner that will alert consumers to the most important information about the cost of their credit transaction. To the extent that H.R. 3011 addresses these concerns about the content, timing, and format of disclosures given to consumers, the Board generally favors the bill's intent.

H.R. 3468, which was introduced by Congressman Schumer, would also amend the Truth in Lending Act to require additional disclosure and advertising requirements for home equity loans. The bill would require certain disclosures to be given with each home equity application. For example, creditors would have to disclose more information about the annual percentage rate and fees charged under a particular plan, as well as provide more information about a plan's payment terms. Creditors would also have to give an example of the periodic payments that would have been required under the plan over a fifteen-year period. The bill would also impose additional disclosure requirements for advertisements of home equity loans. Perhaps the most significant feature of H.R. 3468, however, is the fact that it would impose additional substantive requirements on home equity loans, such as prohibiting the establishment of rate floors and payment schedules that would permit interest-only payments, and prohibiting credit extensions in excess of 75 percent of a dwelling's fair market value.

As I indicated in my comments on H.R. 3011, the Board generally supports the idea of increased disclosures for home equity loans. To the extent that H.R. 3468 would require creditors to provide consumers with more information about the cost of a credit transaction, the Board would generally support this goal. The Board, however, generally opposes the imposition

of substantive restrictions on a particular loan product absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices. At this time, we are unaware of any evidence that such practices exist. Moreover, to the extent that imposing substantive restrictions could affect a creditor's ability to offer this type of loan product, consumers who might otherwise enjoy the advantages that such a product offers could be adversely affected. For example, H.R. 3468 would prohibit plans that allow interest-only payments, a feature that might be attractive to consumers who prefer the lower monthly payments offered by these plans and who fully understand that a balloon payment may result. In addition, the bill would prohibit rate floors for home equity loans with a variable-rate feature. Such a restriction could adversely affect a creditor's ability to offer a home equity product, since creditors have fixed operating costs that may necessitate their placing limits on the minimum rate that can be offered to consumers. Moreover, prohibiting creditors from setting rate floors may be ineffective since creditors may be obliged to seek alternative sources of revenue through increased fees and transaction charges, or through the imposition of higher maximum interest rates or greater interest rate margins. The Board, therefore, urges Congress not to adopt legislation that might unnecessarily restrict the offering of products that, in many cases, benefit consumers, particularly absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices.

Conclusion

I can assure you that the Federal Reserve Board shares the goal that consumers receive adequate information at a relevant stage of the credit-granting process when they contract for home equity loans. We believe that it is particularly important that consumers understand these programs since they may pose a greater risk because of their complexity, the large credit lines generally involved, and the possibility of losing one's home. On the other hand, I want to urge the Congress not to restrict the terms and conditions of home equity programs without sufficient evidence of a clear and unequivocal need for such action.

We look forward to working with you on this important subject.

ever the normal ones are, and there may be others. I didn't mean one.

Ms. SEGER. One problem might be that some organizations do post their own prime rate that in timing terms may be off a couple of days, let's say, from when the New York banks change their prime rate. Now the prime is certainly a well known rate, but the specific timing features of it do vary a little bit. So maybe the prime could be handled in a slightly different way.

Senator DODD. What about the unilateral changing?

Ms. SEGER. OK. On the unilateral issue. First, let me emphasize that these are open-end extensions of credit. It's not like my lending you money for 1 year and for that 1 year it's a contract and we live with the terms that we agreed to upfront.

Senator DODD. But I've secured my home. It's my home.

Ms. SEGER. Yes, that's right. But you are saying that here is an open end extension of credit—I mean, I may make this available forever and ever. It might go 30 years or 40 or whatever. Then, I think if we, as regulators, are concerned with the safety and soundness of these institutions, then we want to be darned sure they maintain some flexibility—I mean, we're not very good forecasters of the future and maybe they aren't either. Therefore, we want to make sure that if conditions do change radically in the future that they will be able to adjust certain terms. Many of the terms that are changed are rather minor ones as far as the consumer is concerned. It might be, let's say, changing the fee from $50 to $55 or something like that. I mean, they are not all of the nature that Congressman Schumer I think correctly is concerned about.

But I think the notion that the terms cannot be changed on this kind of instrument is worrisome to me from a safety and soundness perspective. Maybe what we could do is to encourage some sort of regular review of the terms and have that specified. In other words, you would say the terms of this will be reviewed annually or will be reviewed biannually or something like that. So that the individual consumer would be on the alert that these terms would be up for review in 2 years or 1 year, but that they would be notified of what those changes are.

Senator DODD. I don't disagree with that, and I'm going to turn to my colleague from Rhode Island quickly. The marketplace may dictate that we'll end up with some sort of an annual cap in these areas, but you do have prime plus and actually these things are running 10 to 15 years. They're not like a first mortgage which is a 30-year mortgage. So it is a briefer period of time. I think that's the trend anyway of shorter periods of time. But it is sort of open-ended.

It seems to me—and I understand what you're saying and I don't disagree with it at all, that you don't want to become so restrictive in this area that the advantage of these instruments is lost, and maybe there is something that could be done in that range. But it seems to me that if you're going to leave it open-ended in terms of what that interest rate can be on that consumer and that lender can hold that consumer to that. When that consumer signs that dotted line, there's no opportunity for that consumer to get out of that agreement or unilaterally to change the terms.

Ms. SEGER. Well, except they can borrow from somewhere else and pay this off. That's the ultimate protection.

Senator DODD. That's true. But it seems to me there ought to be—whether you do it every 2 years, but something along those lines where you provide some protection. Again, I can't imagine very many institutions without some very significant reasons would go around changing these, again reputation being as important as it is.

Ms. SEGER. Well, these are offered today by so many different institutions. I mean, it's not just banks that are offering them, but the savings and loans are in it and the number of options that an individual consumer would have, even in a fairly small town, I think are pretty great. I think competition does provide some sort of a shield for the consumer against these outrageous kinds of behavior that Congressman Schumer is concerned about.

Senator DODD. As staff has just pointed out, there are closing costs involved, too, which can run from $500 to $1,000. So if you're moving around from one institution to another that can get pretty costly.

Ms. SEGER. I'm not saying that this would be done every month. I'm just saying that if you really got socked, using Congressman Schumer's example, with a one-shot change from 10 percent to 15 or 16 percent, you would have an alternative; and that is to part company with your lender.

Senator DODD. Thank you very much, Governor.

Senator Chafee.

OPENING STATEMENT OF SENATOR CHAFEE

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Chairman, I am pleased that you have called this hearing today on a matter of increasing concern to all current and potential beneficiaries of home equity loans.

Last year's Tax Reform Act achieved a great reduction in individual tax rates, but balanced these off with the elimination of many tax deductions, credits and exemptions. One of these was the phasing out of the deductibility of consumer interest payments except where related to home mortgages. This has spurred use of home equity loans, where there is equity value in the home over and above any mortgage that may already be in place.

We on the Finance Committee who structured that tax bill knew full well that there would come a time for clarifying several aspects of home equity loans, and not merely from the tax standpoint. Consumer understanding of the matter is essential so that situations do not arise where consumers are not aware of all the ramifications of incurring such debt, even to the point where the underlying collateral—the home—is foreclosed on for nonpayment.

This subcommittee has been diligent in addressing the interests of the consumer. We must see that the consumer has available, at least by the time of application, the critical facts, in easily understood language and numbers, to make a rational choice whether to take advantage of a potential service or not.

The reason why I have a particular interest in this issue is that the price of housing in Rhode Island is rising at a very fast pace. In fact, in approximately the last 2 years, the sale price of single-family homes in Providence, RI, has risen by 62 percent, more than any other of 55 metropolitan areas in the United States. While this may now offer the capacity for sizable home equity loans to owners of those homes, my fear is that, were the economy to enter into a mild recession or stagflation, the owners' capacity to service that debt could become seriously jeopardized, even to the extent of losing their homes. We must do all we can to alert homeowners to this possibility.

But beyond this special concern is the need to be up-front and fair with the American people as to the full costs and benefits of home equity loans. A brief story will suffice. A member of my staff recently went to a major Washington, DC bank for a home equity loan. He read the literature he was given, discussed the matter with a bank officer in the bank, and filled out the necessary forms. This bank offers an interest rate of 5.8 percent for the first 6 months and thereafter 1½ percent over prime. When a second bank officer subsequently called him to tell him the maximum he could borrow, being a function of a percent of his monthly income, it turned out that in computing the interest component of the carrying cost the bank used 24 percent for the floating rate portion. When he asked why this was, he was told that no-one knew where rates would go and that was the maximum that could be charged. The result was that the amount that he would borrow was sharply reduced. Nowhere in the literature or during the discussion with the first bank officer was he notified of this fact.

Accordingly, the focus of legislation should be on greater disclosure for the consumer, and available to him or her no later than the time of application. This disclosure should at least take the form of a prominent statement of the following:

First, the interest rate charged, and any other fees and points to close the transaction. This would include the length of time the teaser rate is in existence, the rate used to calculate the maximum borrowing, and the maximum rate;

Second, if interest only, or interest and principal, monthly payments are in order, that a full or partial balloon payment will occur and that the lending institution is under no obligation to extend further credit;

Third, delinquency in payment could result in the loss of the borrower's home through foreclosure.

Mr. Chairman, I look forward to the testimony and insights of the panel members and a serious discussion of the benefits of legislation on this matter.

Thank you, Mr. Chairman.

Senator **Dodd**. Senator Chafee, do you wish to continue with your questions?

Senator **Chafee**. Yes, thank you, Mr. Chairman.

HOME EQUITY LOANS AND MORTGAGES ARE THE SAME

Let me ask you a question, Governor. Do you think everybody that gets involved with one of these loans fully realizes that it's just like a mortgage, their house can be sold if they don't pay? Do you think people understand that? I notice you have taken some surveys and somehow a mortgage is a very serious thing and people know what that means. A home equity loan has a more gentle tinge to it and doesn't seem so ominous. It's like a line of credit somewhere, that if you don't pay it, you're in trouble but I'm not sure you think of your house getting whisked out from under you.

Do you think most people fully understand that? I notice that both the surveys you dealt with and the surveys referred to in the other testimony indicate that the people that use this are medium to higher income people.

Ms. SEGER. And they are better educated.

Senator CHAFEE. They're better educated so they know what they're getting into.

At these closings—subsequent witnesses I suppose are more equipped to answer these questions than you are because they're right on the firing line giving these loans—there are points involved, points I suppose based on the total amount of the line of credit. Isn't that right?

Ms. SEGER. Yes. Sometimes there are appraisal fees and legal fees.

Senator CHAFEE. And recording fees.

Ms. SEGER. There's a whole group of costs.

Senator CHAFEE. So it's just like getting a mortgage.

Ms. SEGER. Exactly. It basically is, in most cases, a second mortgage, although it could be a first mortgage if you've already paid off your first.

Senator CHAFEE. I was surprised at the amount that is involved in these. You indicated the median size of the account was $25,000, many of which they haven't drawn a penny on.

Ms. SEGER. That's right.

Senator CHAFEE. I don't know why they go to all this trouble and pay all this amount without drawing that. But the median amount drawn you indicated was a little less than $15,000.

Senator DODD. It's a tax deduction.

Ms. SEGER. It was the Tax Reform Act that lit the fuse under this.

Senator CHAFEE. I know. I'm quite aware of that. I'm on the Finance Committee. But still, I'm surprised at the size of the amounts that individuals are running up on these. I think if it went back to the former days when you didn't have to go through this in order to get a tax deductible interest payment—I just don't think most families would be—maybe they would—in debt $15,000 on a line of credit somewhere.

Ms. SEGER. Well, the consumer survey we've been referring to also pointed out the purpose of this kind of borrowing; there are two major ones. One is just debt consolidation. That, I suspect is a tax-related matter because people are paying off their car loans and their loans for a vacation trip or whatever they had at their banks and their credit unions. They are paying those off and replacing them with a loan where the interest is, for many people, fully deductible.

Second, and I think this is probably a good cause and a good purpose, people borrow this way to do some home improvement. And I think that's been fairly traditional, where people would get just a regular second mortgage to remodel the kitchen or put a porch on the back of the house or something like that. So I don't think that that's a flakey kind of abuse of the money.

But I think that very often the incentive is clearly tied to the difference in tax treatment.

Senator CHAFEE. This isn't a facetious question and I really mean it seriously. Is the definition of what is a home pretty clear? I mean, could a boat be a home? Do you know?

Senator DODD. I hope so.

Ms. SEGER. Some of them are expensive enough to be in the home price range. I'm not sure. I think most people think of it as some sort of real property. I'm not a lawyer, so I'd better just pass before I get in trouble.

Senator CHAFEE. Well, I think I know the answer to that. I think in the tax code that a boat can qualify as a home.

Well, thank you very much. I'd just indicate a little surprise at the size of some of these loans, but I come from a very frugal area as opposed to the free-living Californians and places like that.

Senator DODD. I'm intrigued—I'm not privy to what's going on in those discussions at the summit meetings, but it is alarming, the size, and Senator Proxmire talked about the accumulation of consumer debt and business debt, but in this case we're talking about consumer debt, which we're trying to discourage and encourage savings. I wonder how much of a revenue impact this has had, particularly the projected impact, if this is growing at the rate it is, going from $20 billion in 1981 or something and now it's up to $170 billion or $200 billion, just in this home equity loan area.

Senator CHAFEE. Yes. But I think you must have a commensurate decline in other types of borrowing presumably, because they're getting into this to consolidate their debts to get the deduction.

Ms. SEGER. Some is an offset and some other is a net increase. But on the tax hit side or the tax revenue side, let's say you have $100 billion lent, and if the average interest rate on it, just to use a round number, is 10 percent, that's $10 billion in interest that somebody is paying on this in a year, and that's all deductible for most people I should say.

Senator DODD. Almost 100 percent. A lot of these things, John, are interest-only payments and a balloon payment at the end of the period. So the entire amount you're paying on the loan is totally deductible. Of course, you may not be doing a darned thing with your home. There's no requirement to spend the money on your home. As you point out, some people aren't even using the money. It's just sitting there. It's just debt. If you don't have a lot of other tax deductibles you're itemizing, we eliminated a lot of other things, to people who are in that middle income category who don't own a lot of other things, this is a very attractive tax deduction feature.

Ms. SEGER. Maybe we've solved your budget deficit closing problem.

Senator DODD. I don't know if they're talking about it, but it's a serious one.

Senator CHAFEE. Thank you.

Senator DODD. Thank you, Governor Seger.

Our next panel, Alan Fox, Jack Guildroy, and Neil Fogarty. Alan Fox has appeared many times before our committee and subcommittee. He's the legislative representative for the Consumer Federation of America. Jack Guildroy is a member of the National Legal Council of AARP, the Association of Retired Persons. Neil Fogarty is the president of Consumers League of New Jersey. We welcome all three of you.

What I would like to do, if I could, with our witnesses, I think you've already been informed by staff, if you could limit your formal comments to about 5 minutes apiece, we could get to the questions. Obviously, your full statement and testimony is a part of the record. We let Ms. Seger have 10 minutes as a single witness here, but we've got to try to get through before we get bounced out of here depending upon the unanimous consent request and the like.

So, Alan, we'll begin with you, if that's all right. I thank all three of you for being here and look forward to your testimony.

STATEMENT OF ALAN FOX, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA

Mr. Fox. Thank you very much, Mr. Chairman. We appreciate the timely nature of these hearings, the swift response of this subcommittee and Members of the House as well to these important issues. I also want to indicate the gratitude of the Consumer Federation to you for holding these hearings and also to Representatives Price and Schumer for their diligent work on these issues. Their bill represent some different approaches to the concerns here, but they have much more in common than they have points in which they differ and I think they are both very responsive to the consumer needs.

HOME EQUITY LOANS ARE DANGEROUS

Home equity loans are inherently a dangerous game for homeowners. The homeowner is betting the house that he or she can predict interest rates and other economic conditions for the next 10 to 20 years better than the bank can or the other lender. And not only does the lender have all the high cards, but as has been indicated in the discussion so far, the lender can change all the rules any time it wants.

In the words of one banker, Mr. Don Moll, the president of the Tinley Park Bank in Tinley Park, IL:

> Home equity lines of credit are awfully attractive for a banker, especially a banker who doesn't care what happens 7 years from now when his customers have run their credit line up to the limits with casual purchases like neckties and food processors and can't find the cash to repay the whole thing at once.

The reason home equity lines of credit are dangerous to consumers is because they don't have any balance to them. And I believe what this hearing is about and what legislation needs to be about is not eliminating home equity lines of credit but providing a sort of balance to them.

The home equity lines of credit provide the lender with little or no risk and instead require the consumer to accept all the risk. For every attractive term that consumers see advertised in newspapers and elsewhere, there's an equally unattractive feature that does not receive the sort of attention it deserves. The ad may mention low monthly payments, but low monthly payments imply high indebtedness even after years and years of payments of interest only or of interest plus a very, very small part of the principal.

The ads promise easy access to credit, but the corollary to easy access to credit is easy erosion of the equity in consumers' homes and the home is most families' largest saving instrument and that's an issue that we ought to be concerned about.

Low interest rates are advertised, but those low interest rates are usually teaser rates that are followed by variable rates of interest that will go probably nowhere but up from here.

One question we need to ask is whether we're ready for home equity lending that's tied to an 18 to 21 percent prime rate such as the country faced several years ago.

The ads advertise low fees, but those fees, like other terms, are subject to unilateral change by the banks. They can be altered at any time and the low fees can disappear and be replaced by higher fees.

Home equity lines of credit are landmines. They are waiting to go off and when they explode they destroy the consumer's home. There are several factors that can trip them off and not all those factors have become apparent yet because some of them require the passage of some time and some experience with home equity before we will see them. But they are all factors that are easy to anticipate.

One of them is income loss. All the equity in a home doesn't pay the monthly bill on the home equity line of credit. The equity in a line of credit protects the lender, not the borrower.

As the statistics indicate, home equity lines of credit appear to be popular among families with two incomes. The question is what will happen to those families when illness or economic conditions cut their income substantially so that they are unable to make what appeared at the beginning to be very easy payments.

High interest rates are going to explode these landmines. The Consumer Federation of America, The Consumers Union and also banking groups have found that a typical index used to set the rates on home equity is the prime rate plus about 2 percent. Three times as many lenders had floors on their rates as had caps on their rates.

Today the prime is about 8¾ percent. It's declined somewhat recently, but it's still up 1¼ percent since the beginning of this year. In August 1978, the prime was also at about this level. It was about 9 percent. And it also climbed about a point and a quarter in the previous year. Well, it took just over 2 years after that for the prime to climb an additional ten points. That sort of possibility exists and it could destroy people's ability to pay off home equity lines of credit.

These and other pitfalls are inherent in the design of home equity credit plans.

Disclosures can warn consumers of the problems, but they can only go so far. At the present time certainly the disclosures are far from adequate. We're not even talking here about fine print. The fine print seems to be written in invisible ink.

The CFA surveyed 46 lenders in 14 cities, 29 of them advertised in local newspapers, and we found that none disclosed the possibility of balloon payments; none that disclosed teaser rates disclosed what later rates would be; none fully disclosed upfront fees; and only two of the nine that had annual fees disclosed those annual fees to consumers.

I see my time is up. Clearly, we believe that full disclosure as proposed in both of the House bills is necessary. We also support many of the provisions in the Schumer bill which call for specific limits on the nature of these contracts to protect consumers.

Thank you.

[The complete prepared statement of Alan Fox follows:]

TESTIMONY OF

ALAN FOX
LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

AND

MICHELLE MEIER
COUNSEL FOR GOVERNMENTAL AFFAIRS
CONSUMERS UNION

ON

HOME EQUITY LINES OF CREDIT

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS
OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

NOVEMBER 18, 1987

Consumers Union* and Consumer Federation of America** appreciate the opportunity to testify on the issues raised by the recent explosion in marketing of home equity lines of credit. The heavy promotion of home equity loans is a recent phenomenom that raises major concerns for our organizations, and we congratulate you, Mr. Chairman, for calling this hearing in a timely manner.

OUR PUBLIC POLICY CONCERNS

Few developments in the history of consumer lending have threatened the financial well-being of consumers more than the recent surge in home equity lending. This is because home equity loans are a unique combination of several traditional credit features, that, together, multiply the borrower risk inherently associated with personal debt.

Like traditional second mortgages, home equity lines of credit require the borrower to pledge his ownership rights in his residence as security. This not only subjects the borrower to the risk of losing his home, but it also means encumbering the major source of savings for individuals and households, which is no longer available for emergencies and old age.

Like traditional second mortgages, home equity loans also involve large sums of money. This fact alone heightens borrower risk because it means either a protracted repayment period or large installment payments. A recent study by the Federal Reserve Board indicated that the median home equity credit line is about $25,000, and the median amount actually borrowed is almost $15,000.

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*Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education and counsel about consumer goods and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 3.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

**Consumer Federation of America is a coalition of over 230 national, state and local consumer, senior citizen, labor, farm, cooperative and rural organizations which together represent more than 50 million people.

Like credit cards, home equity loans also frequently involve "easy" repayment plans that stretch out the borrowers obligation indefinitely. Borrowers carrying high outstanding balances year after year are exposed to a high risk that at some point in time they will hit a snag in their ability to repay. With home equity loans, sudden illness, unemployment, or unexpected expense could have catastrophic consequences.

Like credit cards, home equity loans are open-ended -- with the ease of writing a check, or even pulling out a credit card, the borrower can get instant cash. Although credit cards have benefited consumers with their convenience, problems arise when it becomes as convenient to put a second mortgage on your principal financial asset.

The risks this new product poses for individual consumers are tremendous. The problems it raises for society as a whole are equally troubling. Although heavy consumer spending may help us avoid a recession in the short term, where will we be in the next cyclical downturn when individuals have no savings to draw on? Where will we be twenty years from now when the baby boomers hit retirement age and have no savings to draw on?

The pros and cons of the tax law revision that has spurred industry's craze for this new product is not an issue before us today. However the risks inherent in home equity lending - risks to society and to individual consumers - should be kept in mind as we discuss the specific features of the HELs that are actually on the market today.

THE SPECIFICS OF THESE NEW PRODUCTS

As we have stated, open-end credit involving large dollar amounts and secured by the borrower's personal residence is inherently risky. The specific features of the home equity products now on the market make an inherently risky product even riskier.

·CAPLESS ARMS

According to recent surveys by our organizations of over 90 lenders, most HELs are an open-end version of the adjustable rate mortgage (ARM) that has now become familiar in the closed-end market. Unlike closed-end ARMs, however, the vast majority of home equity loans have no rate caps and allow unlimited rate increases. This means that borrowers could face significant increases in their minimum repayment amounts, or "payment shock," which increases their risk of delinquency and foreclosure.

We do not argue that ARMs should be abolished. They cushion lenders against increased borrowing costs on relatively long-term loans. However, in the context of both closed-end and open-end credit, we believe that ARM features should reflect a fair allocation of rate risk between the lender and the borrower. We are now seeing such fairness in the closed-end ARM market. Due to secondary market pressure, most closed-end ARMs now contain rate caps, many of which limit periodic rate increases and restrict lifetime rate increases to 5 points above the initial rate.

What is fair for consumers is also good business. Lenders must always balance rate risk (the risk that market rates will rise faster than the yields on their loan assets) with default risk (the risk that their borrowers will not be able to shoulder the debt and will default). With capless adjustable loans, lenders eliminate their rate risk but greatly increase their default risk. We doubt that the investors on the secondary market insisted on rate caps because of a sense of fairness to consumers. They saw that the caps that protect consumers also protect lenders and investors from default risk.

There is no secondary market for home equity loans. We cannot rely on such a market to force home equity lenders into offering a fair product.

·REPAYMENT TERMS

Balloon Payments - A number of lenders in the CU/CFA surveys offer home equity loans that hit the borrower with a balloon payment 5 or 10 years after the loan is made. At that point, the entire outstanding principal is due in one lump-sum repayment. Of course, none of these lenders guarantee that they will refinance the outstanding principal (which would involve substantial cost to the borrower, anyway) when the balloon comes due.

This type of loan feature poses obvious risks. The borrower who cannot come up with the entire repayment amount will have to sell his home to meet the obligation.

Demand Features - Some of the lenders in our surveys that do not explicitly require a balloon payment include contract features that could operate just as onerously. These lenders reserve the right to review the loan periodically and, if vague criteria are met, immediately demand its full repayment.

·PROTRACTED REPAYMENT TERMS

Another feature common to the home equity loans involved our surveys was protracted repayment terms. As an inducement to borrow under these programs, the majority of lenders we surveyed are advertising "easy" repayment terms that frequently involve monthly payments of only the interest accrued on the outstanding balance.

°UNILATERAL CONTRACT MODIFICATIONS BY THE LENDER

The surveys also uncovered what appears to be a common practice among open-end creditors - inclusion in the line of credit contract broad powers under which the lender can unilaterally change the contract terms. This practice was inadvertently uncovered during the conduct of the Consumers Union survey, when a Bank of America spokesperson volunteered that in 1986 that lender had actually changed the formula under which the variable rate is calculated and applied the change to outstanding HEL borrowers.

Since completing those surveys, our organizations have seen HEL contracts used by several lenders. They also include provisions that would allow the lenders to pull the same stunt.

We consider this to be an intolerable practice. Although it appears to be a longstanding feature of open-end credit, until now it has had little significance. Until now, the biggest open-end credit market by far has been credit cards, which involve relatively small balance amounts and for which a post-contract change in rate only means going from bad to bad. Home equity loans involve vastly larger sums of money and a significant item of collateral. Neither should be subject to the tremendous risk involved when a lender can unilaterally change the rules of the game midstream.

°ADVERTISEMENTS

Now that the tax law has given lenders a great way to promote these products, they are being marketed at a fast and furious pace. With lots of creative glitz, the advertisements, which abound in all forms of media, promise easy repayment obligations and the "good life." They fail to mention many of the home equity loan features that we find so troubling:

- Lenders that require balloon payments rarely, if ever, disclose that fact.

- Although lenders promote their programs by advertising low initial rates, they rarely disclose that the rates are uncapped and subject to unlimited increase.

- Although low initial rates are often discounted from the variable rate formula that otherwise applies, some ads fail to disclose the current index rate, leaving the impression that the "teaser" rate will apply indefinitely.

- Lenders frequently promote their loans with the lure of tax deductibility, but rarely inform consumers that there are specific limits on the amount of interest that may be deducted.

- Similarly, lenders fail to fully disclose the upfront costs associated with opening a home equity credit line. These costs can run from $400 to over $1000, and significantly affect, or eliminate, the tax benefit of interest deductibility.

OUR LEGISLATIVE PROPOSALS

We believe the risks inherent in home equity lending warrant immediate legislation to protect consumers and society as a whole. Disclosure legislation is important, but it only goes so far. Home equity loans are complicated instruments the risks of which cannot be eliminated by disclosure. Substantive restrictions on product features must also be enacted.

HR 3011, introduced by Representative David Price, and HR 3468, sponsored by Representative Charles Schumer, both contain many elements we consider crucial. HR 3468, in particular, incorporates many important restrictions on product features necessary to ensure fair treatment of consumers as well as to ensure that features covered by disclosure requirements cannot be altered so as to render disclosure meaningless.

OUR RECOMMENDED SUBSTANTIVE RESTRICTIONS

°Prohibit lenders from contractually reserving the right to change loan terms after the loan agreement is finalized.

°Require interest rate changes to be based on an index or other variable outside the control of the lender (E.g, the lender should not be able to change the loan rate according to the decisions it makes about adjusting its own prime rate).

°Limit rate increases to 2 points per year and 5 points over the life of the loan.

°Eliminate negative amortization, balloon payments, and interminable debt risk by requiring fully amortizing repayment installments that will retire the debt within a fixed, reasonable time period.

Senator DODD. Thank you very much, Alan.

Mr. Guildroy.

STATEMENT OF JACK GUILDROY, MEMBER, NATIONAL LEGISLATIVE COUNCIL, AMERICAN ASSOCIATION OF RETIRED PERSONS [AARP]

Mr. GUILDROY. Thank you very much. I'm Jack Guildroy, a volunteer on the National Legislative Council of the American Association of Retired Persons, which has about 27 million members.

I want to thank Chairman Dodd and members of the subcommittee for holding this hearing on home equity lines of credit. AARP appreciates this opportunity to participate.

According to figures compiled for us by the National Consumer Law Center, persons aged 54 and above held between $15.9 and $37.6 billion in home equity loans in 1986. This represents 965,000 to 2.28 million persons. In addition, data show that the share of finance company home equity loans held by those over age 54 increased from 15.7 percent in 1982 to 21.5 percent in 1985, an increase of 37 percent, or an annual growth rate of 8.2 percent.

Homeownership does not decline very much with the older age groups. Mortgage and consumer debt do decline with age. But the proportions of the oldest segments of the population with consumer debt have grown between 1983 and 1986 from 50.5 percent to 53.5 percent for the 55 to 64 age group, and from 20.2 percent to 25.1 percent for those 65 to 74.

DANGERS FOR THE ELDERLY

With their high incidence of homeownership, low debt load and increasing willingness to take on consumer debt, older Americans could be prime targets for home equity loan lenders. Also, for those with low, oftentimes fixed incomes, and unpredictable expenses like medical bills, home repairs and so on, the lure and potential traps of home equity loans can be particularly treacherous.

Our comments today address only the need for heightened home equity loan disclosures. We support the intent of the provisions in H.R. 3011 and H.R. 3468 designed to enhance home equity loan disclosures. All such disclosures must be provided on or with the application rather than at the time of application. This will enable consumers to compare different home equity offerings and will not require the consumer to incur costs before disclosure of essential information has occurred.

What kinds of disclosure do we support? Facts on varying or periodic interest rates, the method by which they are computed, the effective periods of each rate used, information concerning typical payments and the historic performance of the index to which payments are related, other items which increase consumer costs like closing costs, application fees, service charges, other assessments, a statement that there may be limits on the deductibility of interest payments and that a tax advisor should be consulted; and a statement that indicates that if a home equity loan is secured by the consumer's dwelling, and in the event of any default, the consumer risks the loss of the home.

While these disclosures are essential pieces of information to be provided on or with the application, advertisements which refer to precise terms and conditions of a home equity loan offering must also disclose in the ad key aspects of the offering and other relevant information.

We believe meaningful consumer education is essential to helping consumers understand the implications of home equity loans. The Federal Reserve Board should develop and distribute a pamphlet describing open-end credit plans and the advantages and disadvantages of home equity loans.

The lending institutions must be encouraged to provide their own publications containing such information.

In trying to provide AARP members with more information on home equity loans, our May 1987 news bulletin, received by all AARP members, contained an informative article entitled "Credit Roulette: Home Equity Loans May Put Homes In Peril." A copy of this article is included for your information.

AARP greatly appreciates this opportunity to comment. We look forward to working with the committee toward the enactment of home equity loan disclosure legislation during this session of Congress.

Thank you very much.

[The complete prepared statement of Jack Guildroy follows:]

ATTACHMENT A

DISTRIBUTION OF FAMILIES WITH MORTGAGE AND INSTALLMENT DEBT

AGE	OWN	FIRST MORTGAGE 1983	SECOND MORTGAGE 1983	NO CONSUMER DEBT:	
				1983	1986
Under 25	-	68	2.4	-	-
25-34	53	88.7	10.5	29.3	31.1
35-44	70.7	85.2	13.6	25.4	22.8
45-54	80.2	69.8	8.7	34.8	29.9
55-64	79.1	44.7	3.4	49.5	46.5
65-74	78.7	20.4	.5	79.8	74.9
Over 74	-	4.6	.6	-	-

Source: Federal Reserve Board Survey of Consumer Finances

Attachment B
AARP NEWSBULLETIN
May 1987

Credit roulette

Home equity loans may put homes in peril

To go by the ads, it would seem to be the ideal loan. The money is big, the interest rates low.

As if that weren't enough, the cash can be quick. Just by filling out a form you can, almost instantly, turn the equity you have in your home into a revolving line of credit of anywhere from $5,000 to $100,000 or more.

A lot of people are doing just that, thereby making home equity loans one of the hottest credit vehicles around. By the end of the year, according to one estimate, home-equity credit lines could reach $70 billion, up from $35 billion last year.

But critics fear that many people are taking out such loans hastily, and setting themselves up for trouble later on. "What many people don't realize is that they're putting their homes at risk," says Robert Hobbs, staff attorney for the National Consumer Law Center in Boston.

The ultimate example: Some Las Vegas casinos include "credit checking" machines that authorize cash transfers to customers who use credit cards programmed to reflect home equity as well as other credit sources.

"It's like turning your home into a poker chip," says AARP consumer representative Lee Norrgard. "You could lose thousands of dollars of equity in your home in a single night at the crap table."

There are advantages to home equity loans, however. They make sense for those homeowners with high incomes and financial sophistication. "If you

continued on page 7

Home equity

continued from page 1

have to borrow money, a home-equity loan is one of the best ways to do it," says Mark Kamm, executive vice president for SMR Research, a Budd Lake, N.J., financial-services research firm.

"The interest rates are well below those offered by other types of credit, because lenders use the equity in your home as security for the loan," he points out. "And they are tax deductible," because a loophole in the tax reform law passed last year by Congress allows deductibility (within limits) for interest on such loans.

'Many people don't realize they are risking their homes,' says attorney Robert Hobbs.

Many people, however, should think twice before taking out a home equity loan. Older persons in particular should beware, experts say, because they have more equity in their homes than other people, and thus have more to lose.

Consumer advocates urge homeowners to be on the alert for scams or deals that look too good to be true.

Older homeowners in some communities have been targets for home-equity scams in which unscrupulous lenders, charging usurious rates, have sought to lock them up in loans well beyond their ability to repay.

While most critics concede that such operators are the exception, they note that even respectable lenders are hawking home equity loans with a zeal usually reserved for used car salesmen. Some lenders lure customers by advertising misleadingly low "teaser" rates that last for a short period then rise sharply.

The fact that the rates can change is played down (or noted only in the small print) in many loan ads. Instead, the ads proclaim phenomenally low interest rates, sometimes as low as 5.9 percent or even 3.9 percent. Most of the rates, however, are good only through a certain date, or for a set time period, normally 90 days.

After that most home-equity rates are governed by the variable rate—generally 1 to 3 percentage points above the prime lending rate.

Consumers should also be on the lookout for so-called hidden expenses, such as closing costs, points, fees and service charges attached to a home-equity loan. Such costs may make the loan prohibitively expensive.

Some lenders will do everything they can to hide the actual interest charges until the client comes to their office. There the charges are likely to be explained away.

Still other lenders have raised eyebrows by giving customers the option of paying back only the interest on their home-equity loans for 10 years; the principal is then repaid with one big payment, called a balloon, at the end of the loan period. Critics wonder how borrowers will be able to pay such a large sum at once.

Borrowers also would think twice if they knew the loan they were taking out was essentially a second mortgage.

Says Hobbs, "People who wouldn't dream of getting a second mortgage are taking out home-equity loans. They don't realize that they're essentially the same, with all the same risks."

But home equity loans do have wrinkles of their own. Rather than the fixed loan typical of a second mortgage, lenders offer a line of credit to draw against, much like a credit card. As a rule, the credit line is up to 75 percent of the owner's equity.

Trouble is, borrowers may simply over-extend themselves, because the credit line is always available. This problem can be compounded by the fact that home-equity loans usually carry variable interest rates (rather than the fixed rates typical of mortages). Thus an individual's indebtedness can mount without his awareness.

Another problem is that home-equity loans often carry uncapped interest rates, meaning there are no limits on how high they can rise. Kamm points out that if the prime rate were to shoot up to the 20 percent level, "Monthly payments for home-equity borrowers would soar. This would be a a staggering blow for people on fixed incomes."

To reduce risks to a minimum, AARP consumer analysts recommend that home-equity loan shoppers take the following precautionary steps:

- Know that they could lose their home if they fail to make payments.
- Seek an independent advisor, such as an attorney or accountant, to review all loan terms.
- Determine the repayment schedule (including any balloon payments), the interest rate (and under what conditions it will vary) and fees (all of which are required under the federal Truth-in-Lending statute).
- Learn as much as they can about the lender before signing any note.
- Borrow only what is needed.

Senator DODD. Thank you very much, Mr. Guildroy.

Mr. Fogarty, welcome.

STATEMENT OF NEIL J. FOGARTY, PRESIDENT, CONSUMERS LEAGUE OF NEW JERSEY

Mr. FOGARTY. Thank you for inviting me to the hearing, Mr. Chairman.

REGULATION OF HOME EQUITY LENDING

Why should the Federal Government regulate home equity lending? Well, you have innumerable programs to promote homeownership. Therefore, Consumers League doesn't think that you should be enacting legislation which increases the risk of foreclosure.

Unfortunately, in 1983, the Federal Government preempted the ability of the States to regulate certain home equity terms, such as variable rate lending and balloon payments, in the Alternative Mortgage Transaction Parity Act. You kind of put a handcuff on the States, so I think it's incumbent for the Federal Government to step in with strong laws and strong regulations.

Our position would be that both the State and Federal Government should regulate these problems.

We agree with the prior speakers that disclosure is absolutely necessary. We support what the Federal Reserve is doing. We like the philosophy of Representative Price, and we strongly support Representative Schumer's bill.

However, we think disclosure is not enough and that's why we support the substantive parts of Representative Schumer's bill. Why? Because some credit terms are inherently unfair and no amount of disclosure is going to make these mortgage traps fair.

For example, the unilateral change of terms. We first found out about this because an attorney in Arizona fell into this trap. He took out a home equity line of credit and I forget the exact interest rates but it was bumped up. He thought he had a 12-percent fixed. Six months later he found he had a 15-percent fixed.

That points out this. The consumer is bound for 15 years. The lender is only bound for 15 days because the Truth-in-Lending regulations only require 15 days notice of a change in terms.

These change in terms can change anything. You could double the monthly payments. You could shorten it from 15-year payments to 2-year payments. You could add a balloon. You could change it from a fixed loan to variable, a variable to fixed. You can change the index. You can do anything. It's just extremely unfair to do that, especially if the consumer has already borrowed the money. It offends the whole notion of what a contract is. A contract is the agreement of two people and one side shouldn't be able to rewrite a loan, add terms that were never agreed to, especially after the money has been borrowed.

We note a potential loophole in Representative Schumer's bill. That's one line that we think should be crossed out. That's in the testimony.

Other mortgage traps are demand clauses where, for any reason or no reason, they could just demand all the principal back. We think those should be prohibited.

Balloon payments greatly increase the danger of foreclosure. You either have to pay up, refinance, or lose your house.

In Arizona, on refinancing, some finance companies charge 9 to 10 points. These are more or less traditional mortgages. And we think that those points, excessive brokerage fees of perhaps $3,500—these again are on finance company traditional second mortgages—there ought to be a limit on that. We suggest a limit of 5 percent on all points, brokerage fees, and closing costs.

We are also against the interest-only payments and the negative amortization. The danger here is decades of debt. The children, instead of inheriting the home, may inherit the home equity loan.

We agree with Senator Proxmire about the dangerous level of debt in this country.

As to variable rate caps, we strongly support Representative Schumer's two points per year cap. We would suggest a five point lifetime cap as well. Why? In New Jersey, the usury law allows 30 percent second mortgages. I've submitted to Mr. Kinzler an appendix which shows a couple of 30 percent second mortgages. These are the old closed-end type.

Now I think Congress ought to pay more attention to the traditional closed-end mortgage. Why? Because I tend to disagree with what's been said earlier about this is only a high income product. With the traditional second mortgage, one lump sum, anybody can get them. Here's ads from the newspaper, and some of the terms that are in these ads say "No credit refused", all you need is: "Loans based solely on the equity in your home regardless of income or credit."

Unfortunately, this type of ad is true. Anybody can get a home equity loan. And they also can structure a closed-end as an open-end simply by lending the full amount at once. That's called spurious open-end credit and I guess my point in bringing up the closed-end is that there's a big history of abuse in closed-end credit. One of the reasons why consumer groups are so afraid of open-end home equity lines is this long history of abuses by finance companies and untraditional lenders.

Basically, to close, I'd like to quote an editorial in the Morristown, NJ, Daily Record which was on the subject of home equity regulation. What they said is they reject the dog-eat-dog philosophy of caveat emptor and they say that "We side with those that think it is a proper function of government to keep the sheep from being fleeced, and not just to sharpen the shears."

Thank you.

[The complete prepared statement of Neil J. Fogarty follows:]

·Require that teaser rates remain in effect for at least 1 year.

·Require that rate increases under variable rate plans only apply to drawdowns made subsequent to the increase.

·Prohibit lenders from imposing contract terms that are different from those disclosed before the loan application is submitted unless the upfront disclosure clearly and conspicuously indicates that any particular term is not guaranteed.

·Prohibit use of the term "annual percentage rate" (APR) in describing the annual interest rate on home equity loans and substitute that term with another one that will allow standardized rate disclosure. This will distinguish the rate disclosure for home equity loans (which does not and cannot include all the upfront costs) from the APR that is disclosed for closed-end credit (which does include the upfront cost).

OUR RECOMMENDED DISCLOSURE PROVISIONS

·Timing: The disclosures should come early enough so that consumers can use them to make a shopping decision. As with credit cards, the disclosures for home equity loans should come at the time the lender gives an application form to the applicant. The wisdom of this approach is also reflected in pending regulations proposed by the Federal Reserve Board in regard to closed-end ARMs.

·Content - The upfront disclosures should at least include the following:

- The annual interest rate (For ARMS, this should include the entire rate formula, including the index and margin, and the current rate under the formula. Additionally, if the loan involves a "teaser", or a low introductory rate that is not set according to the formula, the lender should also disclose how long the teaser rate will remain in effect and what the current rate would be under the normal rate formula, with an explanation of what happens at the end of the introductory period.)
- For variable rate loans, the lender should also disclose (a) whether there are periodic and lifetime caps and, if so, what they are, and (b) the frequency with which payment and rate adjustments will be made and how they will be calculated

- All fees required to close the loan and to participate in the plan, and a statement of when those fees are payable and whether they are refundable
- Repayment plans, including a clear description of each repayment options
- Whether the lender is willing to offer a lock-in
- The maximum payment allowed under the terms of the plan and the soonest that that payment could be required
- An historical disclosure of what the loan payments would have been if a representative $10,000 loan were closed 15 years earlier (This and the preceding point are requirements included in the pending FRB regulations for closed-end ARMs.)

- This disclosure should be accompanied by an educational booklet to be provided by the lender. This booklet should describe home equity loans, how payment adjustments work, the rights the lender has against the collateral, and how the applicant can compare open-end costs with closed-end costs. It should also include a table for figuring the tax benefit, if any, of the tax law's interest deductibility provision.
- Statement that the borrower's home is taken as security and that the applicant should consult the accompanying educational booklet for information about what this means.
- Statement that there are limits on the tax deductibility of interest amounts and that the applicant should consult the accompanying brochure for more information.

We believe that legislation incorporating these substantive requirements and the disclosure requirements (with similar requirements regarding advertising) are urgently needed. We look forward to working with the members of this subcommittee toward the passage of effective remedial legislation.

AARP

STATEMENT

OF

THE AMERICAN ASSOCIATION OF RETIRED PERSONS

ON

HOME EQUITY LINES OF CREDIT

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

NOVEMBER 18, 1987

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Introduction

On behalf of the more than 27 million members of the American Association of Retired Persons (AARP), I wish to thank Chairman Dodd and the members of the subcommittee for holding this hearing on home equity lines of credit. AARP appreciates this opportunity to participate. We look forward to working with the committee towards speedy mark-up of home equity loan disclosure legislation.

Background

Home equity loans have become the new engine of consumer finance. Propelled by the phase out and ultimate elimination of the consumer interest tax deduction, the remaining deductibility of interest on home equity loans represents an attractive tax planning device available to millions of American homeowners. With homeowners' equity estimated to be in the trillions of dollars, most lenders are aggressively advertising for home equity loan business.

For responsible borrowers with high incomes and financial sophistication, borrowing against one's home may make sense. However, the risks involved with home equity loans are also very high. While advertisements for these loans may appear enticing, many fail to disclose essential information that can increase consumer cost or jeopardize home ownership. Therefore, essential disclosures must be mandated to make sure consumers know what they are getting into before they take out a home equity loan.

Estimated Use Of Home Equity Loans By Older Americans

The most commonly quoted figures, based on data derived from government agencies, trade associations and consumer surveys, for the amount of home equity credit outstanding in billions of dollars are:

1980 - $ 34
1981 - $ 40
1982 - $ 50
1983 - $100
1984 - $110
1985 - $150
1986 - $170

According to statistics compiled for AARP by the National Consumer Law Center, persons aged 54 and above held between $15.9 and $37.6 billion in home equity loans, in 1986. This represents 965,000 to 2.28 million people. In addition, data indicate that the share of finance company home equity loans held by those over age 54 increased from 15.7% in 1982 to 21.5% in 1985, an increase of 37% (or an annual growth rate of 8.2%).

As Attachment A indicates, home ownership does not decline very much with the older age groups; mortgage and consumer debt do decline with age. However, the proportions of the oldest segments of the population with consumer debt have grown between 1983 and 1986 from 50.5% to 53.5% (for the 55-64 age group) and from 20.2% to 25.1% (for those 65-74).

Thus, with their high incidence of homeownership, low debt load and increasing willingness to take on consumer debt, older Americans could be prime targets for home equity loan lenders. In addition, for those with low, oftentimes fixed incomes, and unpredictable expenses (like medical bills, home repairs), the lure and potential traps of home equity loans could be particularly treacherous.

AARP Position

Disclosures

AARP's comments today only address the need for heightened home equity loan disclosures. To this end, we support the intent of provisions in H.R. 3011 and H.R. 3468 designed to enhance home equity loan disclosures. We believe all such disclosures must be provided on, or with, the application, rather than at the time of application. This will enable consumers to compare different home equity offerings and will not require the consumer to incur costs before disclosure of essential information has occured.

AARP also supports the disclosure of all varying or periodic interest rates, the method by which they are computed, and the effective periods for each rate used. In addition, the consumer must be provided with information concerning typical payments and the historic performance of the index to which payments are related. Other items which can increase consumer cost must also be disclosed, including closing costs, application fees, service charges or other assessments.

Disclosures must also indicate that there may be limits on the deductibility of interest payments and that a tax advisor should be consulted. This is particularly important for the nation's elderly, as illustrated by the following example.

The general rule under tax reform is that interest is still fully deductible up to an amount equal to the original purchase price of the home plus improvements. If an elderly person purchased a home 30 years ago for $40,000 and has put $10,000 worth of improvements into it, interest is only deductible on a home equity loan of $50,000. However, assume the house is paid for and has a current market value of $100,000. If a lender extends a loan based on 75% of the owner's equity, the loan amount would be $75,000. Interest on the first $50,000 would be fully deductible; interest on the remaining $25,000 would be partially deductible under the rules phasing out the consumer interest deduction. Thus, by requiring a statement that there may be limits on the deductibility of interest payments and that a tax advisor should be consulted, the older homeowner above would be able to determine the true deductibility of interest under a proposed loan.

In addition, a statement must be provided which indicates that the home equity loan is secured by the consumer's dwelling and, in the event of any default, the consumer risks the loss of the home.

Advertisements

While the above disclosures are essential pieces of information to be provided on or with the application, advertisements which refer to precise terms and conditions of a home equity loan offering must also disclose, in the advertisement, key aspects of the offering and other relevant information.

Consumer Education

AARP believes meaningful consumer education is essential to helping consumers understand the implications of home equity loans. To this end, the Federal Reserve Board should develop and distribute a pamphlet describing open end credit plans and the advantages and disadvantages of home equity loans. In addition, lending institutions must be encouraged to independently provide their own publications containing such information.

In an attempt to provide AARP members with more information on home equity loans, AARP's May 1987 Newsbulletin, which is received by all AARP members, contained an informative article entitled "Credit Roulette: Home Equity Loans May Put Homes In Peril." A copy of this article is included for your information as Attachment B.

Conclusion

AARP appreciates this opportunity to comment. We look forward to working with the committee towards enactment of home equity loan disclosure legislation during this session of Congress.

Thank you.

CONSUMERS LEAGUE OF NEW JERSEY
FOUNDED IN 1900

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LET THE BORROWER BEWARE: HOME EQUITY LOAN TRAPS
Testimony of Neil J. Fogarty, President
Before the Consumer Affairs Subcommittee,
US Senate Committee on Banking, Housing & Urban Affairs
November 18, 198

Federal Responsibility

Thank you for inviting us to this hearing. The Consumers League of New Jersey believes that the federal government has a duty to protect its citizens from sharp credit practices, unreasonable risks, and unfair loan terms. Numerous federal programs promote homeownership, hence the government should not take actions which increase the risk that consumers will lose their homes to foreclosure. Unfortunately the federal government bears some responsibility for some of the current problems in home equity lending. In 1980 the United States preempted the states' rights to set usury ceilings on first mortgages for residences. In the 1983 Alternative Mortgage Transactions Parity Act, the federal government took away the states' ability to regulate certain home equity loan terms, such as variable interest rates and balloon payments, on first and second mortgages. Taking away the states' regulatory powers imposed a duty on the federal government to step in with strong rules and strong enforcement. But in an atmosphere of deregulation and laissez-faire, we don't believe that substantive regulation has been strong enough.

We support the principle of disclosure to the consumer. Disclosure of risks is absolutely necessary, but disclosure is not enough. Some credit terms are inherently unfair, and no amount of prior disclosure can right the scales. Home equity mortgages are contracts of adhesion whose terms can't be changed by the consumer. Credit math is inherently complicated. Borrowers should not need a crystal ball to foresee the future effects of obscure fine print phrases.

Unilateral Change of Contract Terms:
Rate Rise Suprise

Some home equity lines of credit contain a clause saying that the creditor may, on 15 days notice, change the contract's terms and apply those changes to money already borrowed. So if you had borrowed $20,000 on the understanding that it was a 12% "fixed" rate for 20 years, you could get a letter changing the contract to 18% "fixed," with the new rate applied to outstanding balances. This "rate rise surprise" is like selling a loaf of bread for $1.00, then sending a bill for $3.00 later. Similar unilateral changes in terms could be used by creditors to:

*double your monthly payments,
*shorten the agreed upon repayment period,
*add an unexpected balloon payment,
*change a fixed loan to variable,
*change a true variable loan to a high fixed rate (when interest rates were declining), or
*change the index used on a variable loan.

Since a contract is the mutual agreements of two parties, the unilateral power to rewrite a mortgage offends the very notion of what a contract is. No lender should be able to rewrite terms after the consumer has borrowed the money. The understandings in force when the money was borrowed should continue. If a consumer has paid fees and points to purchase an equity line, he should get the benefit of the bargain. Prohibiting the unfair change of terms would not prevent a lender from using a true variable loan, tied to an independent index, which was agreed upon in the original contract.

While we strongly support most of Rep. Schumer's bill HR 3468, we object to Sec. 2(f)'s potential loophole, which would allow unilateral changes if such were "explicitly described in the loan agreement." We hope that this is not intended to permit general changes, such as 'lender can change the rate, index, or repayment terms.' That would give borrowers no security about what was going to happen during the life of the loan. No consumer should be asked to sign his rights away, possibly signing his house away. Similarly Rep. Price's HR 3011 needs amendment in Sec. 2(c)(3) to ensure that Congress does not inadvertently, in that disclosure bill, put a stamp of approval on unilateral contract changes or a variable loan without an independent index.

Demand Clauses: Calling the Loan

Bill HR 3468, in its section on "Change in Terms," rightly would prohibit changing the contract to give the lender the right to demand full repayment of the loan in a lump sum, whenever the lender feels like it. Such dangerous demand clauses are not within consumer expectations when they apply for mortgages. Consumers expect a time period to amortize the loan. Consumers borrow money to spend it on something. Once spent, most consumers would not be able to come up with the money "on demand." Congress should not allow lenders such an unfair advantage. We suggest a clarification to HR 3468 to ensure that demand clauses cannot be included in the original contract, nor afterwards.

Balloon Payments

A balloon is a gigantic final payment, e.g., borrowing $20,000 with 35 payments of $200/month, then a balloon payment of $20,000. Lenders have no duty to refinance. When the balloon comes due the consumer must either: 1) pay up, 2) refinance on the

Senator Dodd. Thank you very, very much.

Mr. Fox, I know you've got an appointment to get to and you have to leave us by noon, so let me just quickly ask a couple of questions and we'll try and move along with all of you. Again, I thank all of you for your testimony. As usual, Alan, your testimony is excellent and tremendously helpful to the subcommittee.

I wonder if you could point out—my inclination is to sort of agree at least on the question of the prohibition of unilaterally changing some fundamentals. Obviously, a lender has to live in a world which he doesn't control entirely either in terms of what happens with interest rates and the like, and there is a distinction here which you're going to hear—you can't be around, but Tom Harman of Merrill Lynch is going to say this is not the same as a first mortgage.

In the first mortgage you, as the consumer, are getting that money all at once. The lender is making some money on the interest payments as they come in. There's a hedge against what may happen out there in the larger world. Whereas, here, you're not getting the money. You're getting a line of credit. And that distinction should not be lost.

In fact, if you have a cap, arguably you could have a rate go up and all of a sudden the consumer is in the wonderful advantageous position of actually making money on the line of credit, if you will, by reinvesting it in a place, having borrowed it, and actually making money on the spread.

DIFFERENCE BETWEEN HOME EQUITY LOANS AND FIRST MORTGAGES

So there is a distinction there, is there not, and is there some justification for dealing with the home equity loan differently than we deal with the first mortgage, even though it is secured by the same dwelling obviously, the home?

Mr. Fox. Yes, I think there are a number of reasons to make that distinction. At the same time, all the law that exists today with respect to home equity lines of credit, open-end, is based essentially on what we do with credit cards, and we ought to make the distinction between credit cards and home equity lines of credit that are based on a couple of things; most importantly, the amount of money that's involved and the fact that the home is securing the loan.

I guess that speaks to looking for some middle ground between rules based on credit cards and rules based on first mortgages.

I think the most important issues to deal with are the unilateral change in terms and requiring a variable rate index to be something that's out of the control of the lender and publicly available without specifying a single index. Those are the things that are most important because the potential for abuses is the greatest and because the power that's left on the side of the lender is so one-sided.

Senator Dodd. I agree with you on that. Do both of you agree with that as well, that those are really the essential issues here?

Mr. Fogarty. I think that the unilateral change of terms is certainly the most important, and I would throw in the balloon payments as well. I think they are unfair.

Senator DODD. There's no prohibition against the consumer paying the principal.

Mr. FOGARTY. Well, initially the consumer borrows the money to spend it on something and generally won't have it.

Senator DODD. No, but he could be paying it back. Instead of paying $200 a month on a $10,000 loan or whatever it is, he could pay $250 or $300. They are not prohibited from paying principal. So if you know you're faced with that huge nut out there—you're getting the money fairly cheaply, you're taking a chance by letting it run out, but you certainly have to be aware you're going to have to be confronted with that, so why not face it?

Mr. FOGARTY. Well, I'm not sure that most consumers understand the balloon payments or understand many of the things that we're talking about. This is a new product as far as open-end goes. As far as closed-end, it's not.

Senator DODD. How do you respond to that Fed study where 9/10ths of the people responding said they had all the adequate information they needed under the present system?

Mr. FOGARTY. Well, that was only a study of open-end credit and not closed-end credit. There's plenty of abuses.

Here's a car dealer that's offering home equity. You buy a car and they will give you $5,000. In the extremely fine print, it says it's a 14.5 percent home equity loan. So it's not cheap money. It's very misleading.

Anybody in this country who wants a home equity loan can get one from somebody. It's not just banks. It's not just open-end. You can get one from this car dealer. You can get one from a finance company. You can get one from these finance companies—I haven't even heard of these companies and I'm in New Jersey. I don't know who they are.

Senator DODD. Mr. Guildroy, you agree with that, that that's the problem?

Mr. GUILDROY. Well, let me say, as I think I said in my testimony, AARP is extremely sensitive to the substantive issues. On the other hand, we have not yet taken a position on certain of these issues. Our position so far is simply on disclosure.

It's conceivable, it's possible, that 10 weeks from now this will change when our National Legislative Council meets and discusses our priorities for 1988.

Senator DODD. Thank you.

Senator Chafee.

Senator CHAFEE. Thank you.

It seems to me that what we have got here essentially is a line of credit and I think Mr. Fox compared it to a credit card situation where the credit terms are going to change as time goes on. You establish a line of credit with a bank through one of these arrangements, home equity loans, on January 1, 1986, and in the middle of July 1988 you decide to borrow some money. So obviously, the credit terms can't be the same as when you went in there to fix the loan. So you accept there's going to be a variation, right?

Mr. FOX. I think the question is what the limits of that variation are.

Senator CHAFEE. But you think that it ought to be tied to something?

Mr. Fox. Definitely.

Senator Chafee. Two points above prime or five points above prime, whatever it is—something tied to prime?

Mr. Fox. Or a Treasury bill index or something else that's available, yes.

Senator Chafee. Well, that makes sense. Of course, these things have been around I suppose for years. There's nothing original about a home equity line of credit, although obviously they have been developed since the tax bill went through.

I think the key thing is for people to understand in any disclosure that their home is on the line. That's the point you were making and Mr. Guildroy was making, that this is different from most loans. Your home is tied up. It's a second mortgage or a first mortgage. So certainly that ought to be in any disclosure.

Well, thank you all very much.

Senator Dodd. We will be back. We will be in touch with you on these things. We've got a vote to make or we're going to be in trouble. We're going to let you go and get to our last panel when we come back. We will stay in constant touch with you on these things as we progress along with this legislation. We thank all three of you for being here this morning and being patient.

I will just tell Mr. Kirkpatrick, Mr. Ferguson and Mr. Harman, we will be back shortly to take your testimony.

This subcommittee will stand in recess for 15 minutes.

[Recess.]

Senator Dodd. The subcommittee will reconvene.

My apologies to our last panel of witnesses, but I thought we were going to make it without having a vote, but we didn't escape. I thank all three of you for being here today. I will ask each one of you to keep your formal remarks to 5 minutes apiece. Any statements you have that go in excess of that or that you care to submit, of course, will be included as part of the record.

We will begin with you, Mr. Kirkpatrick. I should introduce you as the vice president, Citizens and Southern National Bank, Atlanta, GA, representing the ABA today. We thank you for being with us. H. Earle Ferguson, senior vice president, Crestar Mortgage Corp., Richmond, VA, representing the Consumer Bankers Association; and Thomas D. Harman, who I already mentioned earlier in my questions to Mr. Fox, is the vice president and general counsel of Merrill Lynch Equity Management, Inc. Again, we thank you for being with us. Let's begin in the order that I've introduced you.

STATEMENT OF WILLIAM T. KIRKPATRICK, VICE PRESIDENT, CITIZENS AND SOUTHERN NATIONAL BANK, ATLANTA, GA; REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Mr. Kirkpatrick. Thank you very much.

Mr. Chairman and members of the subcommittee, I am William T. Kirkpatrick, vice president of Citizens and Southern National Bank in Atlanta. I am also a member of the Consumer Credit Division Executive Committee of the American Bankers Association and I welcome the opportunity to present the association's views on home equity lines of credit, and on the two bills introduced recently by Congressmen Price and Schumer.

ATTRACTIVE TO CONSUMERS

The attraction many consumers have for this product is based on convenience and economics. Consumers find that home equity lines provide a convenient way to access substantial amounts of credit at relatively low rates. Knowledgeable consumers prefer to have the ability to accommodate most of their lending needs on their own, thereby avoiding repeated visits to the bank.

Additionally, while interest deductibility is being phased out for most other forms of consumer credit, home equity lines may remain a source of tax deductible credit for many consumers.

Banks and other lenders like home equity loans because they are a secured and relatively simple form of credit. Their lower costs in relation to loan size is reflected in the attractive pricing to the consumer.

The importance of prudence must be underscored. The home equity loan is an excellent financial tool for some consumers when offered properly and prudently by lenders and used properly and prudently by the borrower. If either fails to recognize the purpose for which it is intended, the risks associated with easy access, rate volatility, and lack of payment discipline can result in credit abuse and perhaps in some extreme cases the loss of the home.

With years of lending experience behind them, bankers and other traditional and regulated financial institutions have generally adhered to prudent loan underwriting practices. Bankers base loan approval on the consumer's ability to repay. In other words, qualification is not based on equity alone, but on the consumer's total financial strength, which is evaluated on a case-by-case basis.

I cannot overemphasize that reputable bankers and other traditional lenders are in the lending business, not in the foreclosure business. It is in our best interest to use the most prudent lending practices possible.

A recent ABA survey shows that banks are using conservative criteria for home equity lending. According to the survey, banks commonly reported a loan-to-value ratio between 75 and 78 percent for both fixed and variable rate loans, well within the general industry guideline of 80 percent. The report also found "most banks recognize that questionable advertising might confuse consumers." The survey indicated that the banking industry is already demonstrating a strong commitment to responsible advertising practices.

CONSUMER BROCHURES

Like all credit instruments, home equity loans carry a potential risk. But this risk can be managed by responsible lenders and informed borrowers. Because of this belief, the Association has pioneered public awareness efforts among the financial services industry. Our written material has included a "Home Equity Alert Kit" for lenders, offering voluntary guidelines for advertising; a consumer brochure providing a forthright review of home equity products of which over 180,000 have been distributed; and a lender's 700 page manual to help lenders design responsible home equity lending programs.

This material was followed by a video press release designed to educate consumers and the media on the responsible use of home equity loans. This was transmitted by satellite to more than 700 TV stations covering every major market in the country, and at least 100 TV stations have already used this video in their news programs.

We have attached our consumer brochure to this testimony and will be happy to make the other materials available for subcommittee review.

In effect, much of what is being considered in the two bills before the House, H.R. 3011 and H.R. 3468, our members have been doing on a voluntary basis and will continue to do so.

Nevertheless, we support legislation which provides for reasonable disclosures of pertinent features of home equity financing products. These disclosures, however, should be meaningful, easily understood, and effective for the purposes of evaluating home equity products.

Consumers are an astute group. They will benefit from disclosure legislation that helps them make more intelligent lending decisions. They will not benefit from legislation that tampers with product design and dilutes the very features that distinguish a home equity loan from other kinds of consumer loans.

Two bills, H.R. 3011, The Home Equity Loan Consumer Protection Act of 1987, introduced by Congressman David Price; and H.R. 3468, the Home Equity Loan Disclosure Act of 1987, introduced by Congressman Charles Schumer, are attempting to strike a delicate balance between eliminating potential problems for the consumer with home equity lending without overburdening the industry. With these positive objectives in mind, we would like to briefly discuss some problems with these legislative efforts in hopes that the final legislation will be constructive for all concerned.

Our written testimony will provide more details of our concerns. The Home Equity Loan Disclosure Act of 1987, H.R. 3468, requires that home equity loans be limited to annual percentage rate increases of no more than 2 percentage points in any 12-month period. An interest rate cap is not an appropriate method to satisfy the risk concerns addressed by Representative Schumer's well intentioned approach. The Federal Reserve Board published a survey in January 1987 indicating that rate caps actually work against consumers. While the survey analyzed credit card caps, its conclusions hold true for home equity lines. In an effort to preserve the financial viability of the product, creditors would tighten credit standards to reduce risks imposed by interest rate caps. In effect, some consumers would be denied access to this convenient and economical credit product. Recently, the House of Representatives rejected credit card interest rate caps by an overwhelming margin of 356 to 56. This vote underscores the House intention to use disclosure rather than price controls for the consumer's benefit. We share that view.

We look forward to working with the committee on achieving the goal of ensuring that home equity lines are used wisely. Thank you for letting us discuss these issues today. I will be happy to answer any questions.

[The complete prepared statement of William T. Kirkpatrick follows:]

creditor's terms, (2) refinance elsewhere, if possible, or (3) lose his home to foreclosure. On refinancing, the consumer gets stuck with points and closing costs all over again. In Arizona, as many as 10 points have been charged by finance companies to refinance traditional second mortgages. When the balloon bursts, the borrower is at the mercy of the creditor. Consumers don't benefit from balloons: if they want to repay their loans early, they can do so. Since balloon payments greatly increase the danger of foreclosure, HR 3468 rightly would prohibit them (through specific mention of the term 'balloon payment' in the text of Sec. [illegible] would be helpful).

Interest Only Payments: Negative Amortization

Home equity loans which do not require payment of principal are an expensive trap for the homeowner. The supposed "lower payments" don't save the consumer money. If at the end of 5 or 10 years, the homeowner still owes the same principal, he is incurring an enormous cost of extra interest. The danger is debt peonage for decades. Instead of inheriting houses, the children will inherit an unpaid home equity loan. The longer the loan endures, the more likely that a personal disaster, such as loss of job, health, spouse, second income, not to mention stock crash, will occur. Likewise, negative amortization is unsound public policy, and is a concept of credit math which confuses consumers. We commend HR 3468 on its effort to eliminate these traps.

Variable Rate Problems

Congress recognized that public policy requires that there be a cap on variable interest. As a result of recent legislation, the lender must pick a lifetime cap. But in states like New Jersey which has a 30% usury ceiling, the lender's cap could be 30%. If the prime rate again reaches 20%, many consumers will lose their homes from the payment shock (and the double payment shock with a variable first mortgage). We applaud the two point per year cap in HR 3468, and suggest a five point life cap.

"Teaser" rates are introductory rates which are not set according to the variable rate formula. Often they are used to qualify the consumer. Teaser rates give a false impression of where the future rate variations will be. It is common in variable rate lending to use an index plus a margin, e.g., a Treasury bill index plus 3 points. This formula virtually guarantees that the rate will go up at the first adjustment. The index is not used to get the initial rate. For example:

198?: initial index: 9% (not used)   Teaser rate: 9.5%

1988: index at adjustment: 8%   Adjusted rate charged: 11%
(index 8 plus 3 margin)

This margin works like a thumb on the scales: even if the index goes down, the interest rate will go up at first adjustment.

Congress should consider regulating how variable interest is calculated. We saw a mortgage from a New York finance company which had in the first year, a teaser rate, and in the second year, the teaser rate plus two points-- not until the third year did the rate have any relationship to an index. HR 3468 rightly prohibits floors limiting how far variable rates may drop--these create the unequal situation that the rate may rise sky high, but cannot drop much.

Continuing Second Mortgage Problems

While open ended home equity loans are somewhat new, the continuing history of closed end second mortgage lending presents many abuses. Finance companies and untraditional lenders have recently advertised:

> "Loans based solely on the equity in your home,
> regardless of income or credit"
> "No credit refused."
> "When your bank says "no,"
> Champion says "yes."

We're afraid that these ads are true. Low/moderate income people are getting high risk loans which they have no ability to repay. Seton Hall Law School Clinic represented a man who was given a second mortgage while unemployed. This company sends its debtors a letter frankly admitting that "it is the policy of [the company] to foreclose very rapidly in case of default..." In Maryland, the First American Mortgage Co. was accused of charging 141% interest through the device of retaining forty (40) points: consumers received thousands of dollars less than the nominal principal. This company and Landbank Equity of Virginia are also accused of swindling investors in the secondary market. In the last year in New Jersey, at least one mortgage company went bankrupt, one disappeared, and a third had its records seized by the FBI.

We have seen 30% second mortgages in New Jersey and 39% mortgages from Arizona. Large finance companies in Arizona routinely charged 19% to 25% on second mortgages in 1985 according to the Arizona Superintendent of Banks. Mortgage companies use second mortgages to refinance first mortgages, then claim the benefit of the 1980 federal preemption of state usury laws as to first mortgages on residences. We don't think Congress intended to permit unlimited interest on these questionable loans. Since interest rates have declined from their abnormal 1980 levels, the 1980 preemption has outlived its purpose, and should be repealed. If not repealed, it should be limited to true purchase money first mortgages, and the states should be given another opportunity to opt out of it.

Some of the generic problems in closed end second mortgage lending include:

*excessive points, unearned closing fees,

*large brokerage fees, e.g. $800 to $5,500, according to the Wall Street Journal, (1/29/86)
*balloon payments,
*re-charging 10 points for a refinancing, and
*increasing the interest rate on refinancing.

These continuing abuses in closed end second mortgages can easily be repeated when finance companies make home equity loans. Congress has cause for concern when homeowners risk losing their homes-- if Congress is concerned about open end home equity problems, a fortiori it should be concerned with traditional second mortgages. Congress has the power to regulate all of the different creditors which make second mortgages.

We worry when a large bank in New Jersey advertises on TV "unlock the equity in your house," and shows money falling out of the ceiling. But your ability to repay depends on your income-- you can't send in a door or window as payment. Congress could also consider regulating the use of credit cards linked to second mortgages: otherwise it's charge a blouse, put a lien on your house. This trivializes mortgage lending.

Instead of moving to protect the homeowner, in 1982 Congress inadvertently gave lenders a green light to try tricky credit terms. The federal Alternative Mortgage Transactions Parity Act (AMTPA), 12 USC 3801, actually takes away part of the power of the states to regulate variable rate mortgages, balloon payments, etc. on home equity loans. This law should have been aimed at purchase money first mortgages, but it also includes all second mortgages, and covers (overbroadly) all "housing creditors," including the finance companies and untraditional lenders. We're not satisfied that the current federal regulations are adequate to substitute for the preempted state laws. A better approach would be to repeal AMPTA, or limit its scope, or let the states opt out of it. Then there could be a two pronged effort to protect American homeownership: the federal government could provide a safety net of protections, which the states would be free to supplement.

If a person sees a neighbor about to fall in a hole, he has a duty to warn him. If the government sees a person digging holes as traps, it ought to stop the practice. We think the 1982 AMTPA unfortunately is a shovel which helps lenders dig mortgage traps in home equity lending. We applaud this current effort of Congress to explore home equity problems and to find solutions.

Statement of the
American Bankers Association
on
Home Equity Lines of Credit
before the
Subcommittee on Consumer Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate

November 18, 1987

Mr. Chairman and members of the Subcommittee, I am William T. Kirkpatrick, Vice President of Citizens and Southern National Bank in Atlanta, Georgia. I am also a member of the Consumer Credit Division Executive Committee of the American Bankers Association and a faculty member of both the American Bankers Association's National School of Real Estate Finance and the National Consumer Credit School where I teach courses on home equity lines of credit.

The American Bankers Association is the professional and trade association for the commercial banking industry. The combined assets of our members represent approximately 95 percent of the industry total. We welcome the opportunity to present the Association's views on home equity lines of credit and on the two bills introduced recently by Congressman Price and Congressman Schumer.

Before I offer our suggestions, it is important to understand the recent developments surrounding the growth of this product, namely how home equity loans work, why they have become so popular with consumers and lenders, and how lenders evaluate a consumer's creditworthiness.

A home equity loan is a derivation of the traditional second mortgage. Many of us remember the traditional second mortgage -- which was and still is a fixed-rate fully amortizing loan where borrowers received the full amount of the loan following approval. Payments are made in monthly installments usually over 15 or 20 years.

Today, the most popular kind of home equity loan is the home equity line of credit which is a revolving credit line in which a consumer can borrow and repay against the line of credit as needed. A specific revolving credit period may range from five to ten years. During this period, the borrower may choose to pay a portion of the principal plus interest or interest charges only. Usually there is an adjustable interest rate which is indexed to a short-term market rate like the prime rate and is subject to increase and decrease regularly as the index rate changes. Rates are typically lower than other consumer loans.

Following the revolving credit period of a home equity loan, any outstanding balance generally converts to a 15 year or 20 year amortizing loan at a fixed rate. However, some lenders may require a balloon payment where the balance is due at the end of the revolving period in one lump sum. Depending on the market, this balloon payment is often a feature of the product that has been added in response to consumer requests.

Like any mortgage loan, there can be application fees plus a combination of appraisal, title, insurance, attorney, recordation and similar fees depending on the lender and location.

The attraction many consumers have for this product is based on convenience and economics. Consumers find that home equity lines provide a convenient way to access substantial amounts of credit at relatively low rates. Knowledgeable consumers prefer to have the ability to accommodate most of their lending needs on their own, thereby avoiding repeated visits to the bank.

In addition, these loans are particularly attractive because while interest deductibility is being phased out for most other forms of consumer credit, home equity loans *may* remain a source of tax-deductible credit for many consumers.

Banks and other lenders like home equity loans because they are a secured and relatively simple form of credit. Their lower cost in relation to loan size is reflected in the attractive pricing to consumers.

The importance of "prudence" must be underscored. The home equity loan is an excellent financial tool for some consumers when offered properly and prudently by lenders and used properly and prudently by borrowers. If either fails to recognize the purpose for which it is intended, the risks associated with easy access, rate volatility, and lack of payment discipline can result in credit abuse and perhaps in some extreme cases, the loss of the home.

With years of lending experience behind them, bankers and other traditional and regulated financial institutions have generally adhered to prudent loan underwriting practices. Bankers base loan approval on the consumer's ability to repay. In other words, qualification is not based on equity alone, but on the consumer's total financial strength, which is evaluated on a case-by-case basis. The most important guideline in measuring the ability to pay is the *monthly-debt-to-income ratio* which relates to monthly gross income the monthly payment required to amortize the full home equity line of credit along with any other fixed monthly payments. The ratio can range between 30 to 40 percent but can vary based on other borrower circumstances.

The other major credit determinant is the combined *loan-to-value ratio* or the ratio of all debt (first mortgage plus the equity lines as a percent of the appraised value of the home). Combined loan-to-value ratios generally range from 70 to 80 percent and provide the cushion against a decline in the value of the home should the lender have to look to the home to repay the loan. The home, however, should *NEVER* be looked on as the primary source of repayment.

I cannot overemphasize that reputable bankers and other traditional lenders are in the *lending* business, *not* in the foreclosure business. It is in our best interest to use the most prudent lending practices possible.

A recent American Bankers Association survey shows that banks are using conservative criteria for home equity lending. According to the American Bankers Association's 1987 Retail Bank Credit Report, regardless of size, banks commonly reported a loan-to-value ratio between 75 to 78 percent for both fixed and variable rate loans, well within the standard guideline of 80 percent. The report also found "most banks recognize that questionable advertising might confuse consumers...." The survey indicated that the banking industry is already demonstrating a strong commitment to responsible advertising practices.

While we have heard a lot about the sudden growth of home equity loans, the simple fact is that second mortgages in general have been growing in popularity since 1980. According to the National Second Mortgage Association, second mortgage outstandings have grown form $34 billion in 1980 to $175 billion in 1986, and $35 billion of that was in home equity loans.

Like all credit instruments, home equity loans carry a potential risk. But this risk can be managed by responsible lenders and informed borrowers. Because of this belief, the Association has pioneered public awareness efforts among the financial services industry. Last fall, the Association formed a home equity task force to educate lenders about responsible advertising procedures. I chaired that task force and in December 1986, the task force produced a "**Home Equity Alert Kit.**" It offers voluntary guidelines for responsible home equity advertising. We distributed thousands of these kits to bankers and to anyone else who requested them, free of charge, because of our commitment to responsible advertising.

In conjunction with this lender education effort, the American Bankers Association also compiled a comprehensive 700-page guide, "**The Home Equity Lending Manual**" for bank officers. This publication helps bankers design responsible home equity loan programs.

We then produced a consumer brochure, "**What You Should Know About Home Equity Loans.**" It gives consumers tips on both the benefits, and most importantly, on the potential pitfalls of these loans, and it has been widely recognized for being a forthright review of home equity financial products. To date, more than 180,000 brochures have been distributed to the public.

Our written material was followed by a video press release designed to educate consumers and the media on the responsible use of home equity loans. Featured in the video tape are Mark W. Olson, immediate past national president of the American Bankers Association who is also president of Security State Bank in Minnesota and Alexandra Armstrong, president of a professional financial planning firm. Transmitted by satellite to more than 700 TV stations (covering every major market in the country), at least 100 TV stations have already used this video in their news programs.

We have attached our consumer brochure to this testimony and will be happy to make the other materials available for Subcommittee review.

In effect, much of what is being considered in two bills before the House, H.R.3011 and H.R.3468, our members have been doing on a voluntary basis and will continue to do so.

Nevertheless, we support legislation which provides for reasonable disclosures of pertinent features of home equity financing products. These disclosures, however, should be meaningful, easily understood, and effective for the purposes of evaluating home equity products.

Home equity legislation should be limited to disclosure requirements. Heavy handed legislation could strip away the very features of the home equity product which appeal to consumers. Attempts to reduce the "risk" associated with a variable rate loan like the home equity line, may result in reducing the key benefits of the variable rate loan -- attractive rates and flexibility.

Consumers are an astute group. They will benefit from disclosure legislation that helps them make more intelligent lending decisions. They will not benefit from legislation that tampers with product design and dilutes the very features that distinguish a home equity loan from other kinds of consumer loans.

Two bills, H.R.3011, The Home Equity Loan Consumer Protection Act of 1987 introduced by Congressman David Price and H.R.3468, the Home Equity Loan Disclosure Act of 1987 introduced by Congressman Charles Schumer are attempting to strike a delicate balance between eliminating potential problems for the consumer with home equity lending without overburdening the industry. With these positive objectives in mind, we would like to discuss some problems with these bills in hopes that the final legislation will be constructive for all concerned.

The Home Equity Loan Consumer Protection Act of 1987

Last month, I testified before the House Subcommittee on Consumer Affairs and Coinage in its review of H.R.3011, Congressman David Price's bill on disclosure and advertising regulations for home equity lines of credit. At that time I underscored our long standing position that we are committed to the adequate disclosure of home equity loan features. As we have consistently indicated, we support the legislative goals of the Price bill.

However, the Price bill should be amended to allow three days in which to provide for the mailing of initial disclosure information regardless of how the initial application for a home equity line has been made -- in person, by phone or by mail. The Price bill amends the Truth in Lending Act -- Regulation Z -- which already affords three days for the right of rescission. Moreover, the Real Estate Settlement Procedures Act requirements under Regulation Z also provide three days for full disclosure. In effect, a three day period for disclosure of home equity information would ensure uniformity under Regulation Z and prevent errors which could have serious ramifications. Representative Schumer's bill also fails to provide three days for such disclosures although it also revises Regulation Z.

The Price legislation should also indicate clearly that only a completed written application should trigger the disclosure requirements. This will help prevent customers from arguing that they made an application when they only partially completed one. Representative Schumer's bill partly addresses this problem by stating that written applications would require disclosures. But it too should go a step further to require that the application be completed.

Senator DODD. Thank you very much.
Mr. Ferguson.

STATEMENT OF H. EARLE FERGUSON, SENIOR VICE PRESIDENT, CRESTAR MORTGAGE CORP., RICHMOND, VA; REPRESENTING CONSUMER BANKERS ASSOCIATION

Mr. FERGUSON. Thank you. Mr. Chairman, members of the subcommittee, I am Hef Ferguson, senior vice president of Crestar Mortgage Corp., headquartered in Richmond, VA. I am appearing today on behalf of the Consumer Bankers Association. Both individually and on behalf of CBA, I want to thank the subcommittee for the opportunity to testify on the subject of home equity lending generally, and to address certain legislative and regulatory initiatives on that subject.

Home equity loans and lines of credit are proving to be among the most popular and useful financial products in a generation. Recent surveys show consumers are using them prudently. Similarly, lenders are making loans with due regard to both commercial reason and consumer interests. Home equity credit is already subject to significant regulation and further regulatory proposals are being considered at this time by the Federal Reserve Board.

The CBA position is relatively simple. We believe that overly restrictive new legislation on home equity credit is unneeded. We ask that congressional consideration be limited to modifications of the existing disclosure scheme, such as are proposed in H.R. 3011 introduced by Congressman David Price of North Carolina. Our testimony shows that present circumstances warrant nothing more than the earlier disclosure of essential credit shopping information.

INACCURATE PERCEPTIONS

Many perceptions concerning home equity lending are really inaccurate in many cases. Initiatives to impose increased restraints on home equity lending practices, such as are contained in H.R. 3468, introduced by Congressman Schumer, are based in part on the assumption that borrowers and lenders are bent on rushing irresponsibly toward the brink of financial ruin. This is not supported by surveys of consumer usage patterns, delinquency and default rates, and industry credit-granting procedures, educational efforts and foreclosure experiences. Both the Federal Reserve and the CBA have completed such surveys on the subject in 1987.

In addition to prudent lending practices, home equity line credit providers have also taken a proconsumer stance by providing credit-shopping guidelines to both their financial services colleagues and consumers generally. My company has done so in its "What You Need To Know" application kit as well. CBA has issued approximately 100,000 copies of a brochure attached as appendix A directly to consumers or to its members as a customer relations and educational tool.

We do not suggest that improvements in the disclosure and dissemination of credit-shopping information areas cannot be made. However, there is simply no evidence of need for the imposition of increased restrictions on home equity lending practices.

Any new disclosure scheme should be simple, consistent with existing law, and not redundant. If Congress deems it necessary to provide for additional consumer protection in this area, it should be limited to the types of application stage disclosures proposed in H.R. 3011 by Congressman Price.

In particular, CBA would oppose any intrusive restrictions on home equity line practices such as those proposed by Congressman Schumer in H.R. 3468. These restrictions include interest rate caps, loan-to-value ratios, prohibitions on certain interest and accrual practices or overly restrictive initial discount, advertising, rate change or call limitations. They would prove harmful to consumers by limiting equity line availability to a select few of the least risky customers. Others wanting or needing to liquidate their equity could sell it, but could not really borrow against it.

There is also a wealth of existing disclosure law and consumer protections available now. In crafting any additional disclosure requirements, the vast array of consumer protection laws presently applicable to home equity credit and present regulatory movement to fine-tune those laws must be considered.

Major existing constraints include the recent congressional mandate that creditors must include interest rate caps on all variable rate equity lines. In its regulations to implement that law, the Federal Reserve Board has taken a broad view of the legislative intent. For example, the regulations cover fixed-rate transactions if the creditor reserves the right to change terms as well as transactions with explicit rate adjustment features.

The Federal Truth-in-Lending Act contains time-proven regimen for advertising and disclosure of home equity credit terms. Home equity transactions are also subject to the right of rescission, a 3-day cooling off period.

The Federal Reserve Board staff has indicated recently that a comprehensive proposal for new home equity disclosures under regulation Z will be presented to the Board in early December 1987.

The Truth-in-Lending Act rules on disclosure and rescission are reinforced by other Federal and State disclosure laws and by Federal and State disclosure laws as well as Federal and State laws prohibiting false advertising and deceptive and unfair practices or otherwise limiting credit practices.

We believe it is inadvisable to legislate sweepingly in an area that is in such a state of flux and development as home equity lending.

To suggest that first mortgage loan limitations or disclosures are appropriate for equity lending is to ignore the substantial differences in the purposes, uses and practices respecting these forms of credit. Home equity lending requirements must be based solely on the realities of that type of lending.

Much has also been said of the potential for consumer abuse in home equity transactions that permit the creditor to terminate or accelerate at will. Some forms of acceleration clauses have been standard provisions in credit transactions for years. They are a necessary precaution against the debtor's nonpayment or other default. Without a provision permitting the creditor to call the entire debt due in the instance of default, the creditor would be forced to separately sue on each installment as it fell due. We would also note that there is really a well-established body of State law on this subject currently.

Finally, we have certain concerns as to the proposed expansion of Truth-in-Lending law beyond the bounds of its original purposes and congressional intent.

In conclusion, the Consumer Bankers Association is proud of its record of supporting well-drafted legislation to improve the flow of information to consumers and to prohibit truly abusive and anticompetitive practices. Regulatory refinement of existing law is underway at the Federal Reserve Board, and we suggest the subcommittee closely monitor that activity.

Thank you very much.

[The complete prepared statement of H. Earle Ferguson follows:]

Furthermore, in situations where specific fee information is not available at the time of the application, we urge that a lending institution be permitted to explain how fees will be determined. In situations where fees cannot be ascertained at the time of application -- such as appraisal fees -- we suggest that these fees be identified generally and lenders disclose the exact fees involved within a reasonable amount of time beyond the initial disclosure period, when the fees are more exact.

The American Bankers Association supports the concept of providing some type of financial example of a home equity line as long as it educates consumers and does not cause compliance problems for banks. However, we think that it would be best for the Federal Reserve Board to have the authority to draft that example to be provided to consumers rather than locking a financial model into legislative language. The Federal Reserve Board has considerable experience in this area and could develop an appropriate financial example.

We also urge that the Price bill be amended to provide 180 days for compliance after the regulations have been finalized and that federal law supercede any state laws. The 180 day provision is required for adequate review and compliance by banks. Federal preemption would prevent consumer confusion in comparison shopping among different home equity products marketed on a regional or national basis.

Overall, we believe the disclosure approach of the Price bill would be helpful to consumers without discouraging lenders from continuing to market a credit product beneficial to the public.

We will now address in more detail some of the provisions of Representative Charles Schumer's bill, H.R.3468.

The Home Equity Loan Disclosure Act of 1987

H.R.3468 requires that home equity loans be limited to annual percentage rate increases of no more than two percentage points in any twelve month period. An interest rate cap is not an appropriate method to satisfy the risk concerns addressed by Representative Schumer's well intentioned approach. The Federal Reserve Board published a survey in January 1987 indicating that rate caps actually work against consumers. While the survey analyzed credit card caps, its conclusions hold true for HELs. In an effort to preserve the financial viability of the product, creditors would tighten credit standards to reduce risks imposed by interest rate caps. In effect, some consumers would be denied access to this convenient and economical credit product. Recently, the House of Representatives rejected credit card interest rate caps by the overwhelming margin of 356-56. This vote underscores the House intention to use disclosure rather than price controls for the consumer's benefit. We share that view.

The Association also believes that locking "teaser" rates into a one year period does not serve the best interest of consumers. A "teaser" rate is just another name for an introductory or short term rate. It serves as a marketing incentive, and the consumer benefits during some specified time with a lower

rate. The institution benefits competitively by attracting new business. Appropriate advertising and disclosure guidelines make clear to the potential customer that initial short-term rates provide nothing more than an initial inducement and do not apply to the term of the loan.

H.R.3468 mandates a maximum loan-to-value ratio for home equity lines of credit. Ironically, such a proposal would take the loan-to-value ratio analysis out of the hands of those who are most skilled at determining the ratios and who have already exhibited a conservative approach to setting them. Lenders are best equipped to set adequate ratios and determine the value of property in their local communities and the risks in lending based on those values. Most importantly, we cannot lose sight of the fact that bankers base loan approval on the consumer's ability to repay, not only on the value of the collateral.

This proposal also has an alarming aspect in that it would authorize the Federal Reserve Board to reduce from normal standards home equity loan-to-value ratios in a declining residential neighborhood. Here, lenders might be forced to deny qualified customers the right to use an appropriate percentage of their equity just because the neighborhood has been declining. Again, let the bankers' good and conservative judgment prevail!

Another provision of H.R.3468 would restrict creditors' rights to terminate or modify a home equity contract. Assuredly, the goal of this proposal is to protect consumers from becoming vulnerable when a creditor exercises the option to terminate or modify the contract. When this situation occurs, industry practice has been to convert the open-end line of credit into a full amortized closed-end agreement. As a result, while the consumer is precluded from making additional draws on an open line of credit he is not faced with the catastrophic possibility of foreclosure.

H.R.3468 would also prohibit lending institutions from either "directly or indirectly" utilizing their own index for home equity lines of credit. Such a prohibition reflects confusion over the nature of internal prime rates. A bank's internal prime reflects the overall cost of funds to the lending function. An internal prime is not linked solely to a consumer product -- such as home equity lines of credit. Instead, it serves as the base rate for virtually all the bank's commercial accounts. Hence, the notion that a bank would manipulate its internal prime to "gouge" consumers is ill founded. Such manipulation would affect every commercial account that the bank manages.

A requirement to use an external index raises another question. So-called "outside" indices such as the Wall Street Journal prime are really a composite of the indices of the top 20 banks. If a lending institution is one on that list, and it is prohibited from even "indirectly" using its prime, it would be prohibited from using a major standard external index.

H.R.3468 provides that an extremely comprehensive booklet on home equity lending be distributed to consumers. The Association agrees that a brochure can be very helpful to consumers and in fact it has already developed and distributed to consumers 180,000 copies of a forthright presentation on the opportunities and risks of home equity loans. However, rather than locking a brochure's requirements into legislative language, we urge that the Federal

Reserve Board be given responsibility for developing the brochure to ensure that every lending institution distributes the same publication and its contents are a major benefit to consumers.

We also are concerned with a provision in H.R.3468 which would limit any increase in the annual percentage rate (APR) to new credit extensions only. Such a provision would have at least two results. First, lenders who offer an APR linked to prime would seek to set higher rates initially to hedge against possible rising market rates. Secondly, the proposal would result in tiers of interest rates applying to separate outstanding balances. The results would be a nightmare for both consumers to track their finances, and lenders to manage the loan accounting.

A provision to prohibit balloon payments would be difficult for many borrowers. Lenders have found that balloon payments a product feature often specifically requested by the consumer. For example, balloon payments are of considerable benefit for those individuals who are planning to sell their home in the near future or who receive lump sums of money periodically, such as commissions or bonuses.

The requirement that the payment schedule for each credit extension full amortize principal and interest over a fixed period of time is troublesome. There are home equity plans which provide initially for interest-only payments and after ten years enter a "payout" phase in which fixed payments of both principal and interest are made at a rate reflecting the amortization of the outstanding balance. These do not constitute balloon payments but are part of a plan which also accommodates consumers in situations where they need the money initially to defray expenses such as college costs and later will have the money to repay both interest and principal. The proposal precludes banks from offering these tailored plans even though they meet consumer needs. In short, balloons and other interest-only plans are a benefit to some people, and they should not be denied the right to these features.

As indicated in earlier comments, the legislation should defer to the Federal Reserve Board for construction of a financial example for lenders to distribute to illustrate the effects of variable rates.

Our Association is concerned with the advertising provision in H.R.3468 which would expand those terms which "trigger" the obligation to provide additional information in the advertisement. The Congressman has proposed that "any implicit or explicit reference to any term or provision" which is required to be included in the loan application would trigger the need for further clarification if those references were used in advertisements. That clarification would require a laundry list of explanations. As you may recall, the Federal Reserve Board's revisions of Regulation Z in 1981 included a simplification of the advertising section's "trigger terms." The number of terms which would trigger additional explanations in advertisements were reduced because the Board concluded that such revisions would not only improve compliance but would also "provide consumers with the information most relevant to credit shopping."

The proposal to expand the terms which trigger additional disclosures in advertisements could have a negative effect on the marketing of home equity products thus increasing consumer difficulty in comparison shopping among various home equity lines of credit. Other disclosure proposals coupled with Regulation Z requirements ensure that consumers would have all relevant information they need prior to concluding the loan agreement. Hence, much of what is being proposed for inclusion in advertisements is unnecessary as well as confusing.

H.R.3468 does not address specifically two important issues -- the length of time provided for implementation of regulations and whether federal law will preempt state laws on home equity lines of credit disclosures and advertising. As noted earlier, we believe it is in the best interests of all involved to provide sufficient time for the Federal Reserve Board to draft regulations properly and for banks to review and implement them. With this in mind, we urge that at least 180 days be provided for compliance after the regulations have been finalized by the Federal Reserve Board.

Finally, federal law should preempt totally any state law relating to disclosures or advertising of home equity lines of credit. Many home equity lines of credit are marketed regionally, and adherence to individual state laws could prove confusing for consumers and present compliance problems for lending institutions.

In conclusion, our Association believes that home equity lines of credit have proven to be an excellent product for consumer and lender. I also want to stress again the mutual concern of the American Bankers Association with the Congress in protecting consumers from the loss of their most important possessions -- their homes. In effect, not only do we believe there must be prudence in utilizing home equity lines of credit, but that prudence should also be the guide in legislation on this subject. Overregulation of this product could restrict lenders from offering home equity lines of credit -- a result harmful to the public.

We look forward to working with the Subcommittee on achieving the goal of ensuring that home equity products are used wisely.

Thank you for letting us discuss these issues today. I will be happy to answer any questions that Subcommittee members may have.

HOW TO SHOP FOR A HOME EQUITY LOAN

A CHECK LIST OF QUESTIONS YOU SHOULD ASK LENDERS:

- Is there an introductory interest or "teaser" rate on the loan?
- If so, how long will the introductory rate last?
- What is the annual percentage rate?
- How is the rate established?
- How often will the rate change?
- How much money will the bank lend me?
- Does the variable-rate home equity loan have an interest ceiling or "cap" to protect me if the rates go up?
- Is there a limit or "floor" as to how low the rate may decline?
- What kinds of up-front costs must I pay for the loan?
- Is there an annual or other fee(s) associated with the loan?
- What are the repayment terms and options?
- Will I be faced with a lump-sum "balloon" payment where the entire balance of my loan is suddenly due in one payment?
- Once the loan agreement is signed, are any terms subject to change?
- What is the length of the loan?
- How do I access the funds in my loan?
- What are the minimum withdrawal requirements?
- Is there a conversion clause in my agreement that will allow me to change from a variable to a fixed-rate loan?

A HOME EQUITY LOAN IS AN IMPORTANT YET COMPLEX FINANCIAL TOOL. TAKE TIME TO SHOP CAREFULLY. TALK TO YOUR LOCAL BANKER TO DETERMINE IF A HOME EQUITY LOAN IS RIGHT FOR YOU.

A service of the American Bankers Association

AN OLD CONCEPT, A NEW IDEA

Many consumers remember the traditional second mortgage—a fixed-rate fully amortizing loan where borrowers, upon loan approval, received the full amount of the loan and paid it back in monthly installments usually over 15 or 20 years. The home equity loan is really a derivation of the traditional second mortgage and it comes in two varieties.

TWO KINDS . . .

The newest and most common kind of home equity loan is the **home equity line of credit**. This is a revolving credit line where a consumer can borrow and repay against the line of credit as desired for a specified revolving credit period which may range from five to 10 years. During this period the borrower pays interest only or a portion of the principal plus interest. The interest rate is an adjustable one which is indexed to a short-term market rate like the prime rate and is subject to increase and decrease regularly as the index rate changes. After the revolving credit period, the outstanding balance may convert to a fully amortizing loan which is repayable in monthly installments over a period that could range from 10 to 20 years. However, some lenders may require a "balloon payment" where the entire balance is due at the end of the revolving period.

The other kind of home equity loan is very similar to the traditional fixed-rate second mortgage and does not include a revolving credit feature. These loans which are known as **home equity installment loans**, may have either a fixed-rate or variable rate.

WHAT IS MY POTENTIAL LOAN AMOUNT?

You may be eligible for an equity loan up to 80 percent of the appraised value of your home less the balance on your first mortgage:

		example	your home
appraised market value of home:		$110,000	$______
x 80%:		x 80%	x 80%
		$ 88,000	$______
minus the balance of your first mortgage:	−	$ 50,000	$______
potential home equity loan amount:		$ 38,000	$______

CAN I AFFORD IT?

Bankers will analyze your total financial strength before approving a home equity loan. Loan approval is based on a consumer's ability to repay. A standard debt-to-income ratio may be used as a very broad guideline to determine repayment ability. This ratio relates the monthly payment required to amortize the full loan amount (not the amount used) along with other fixed monthly payments and compares it to monthly gross income.

AM I ELIGIBLE FOR A TAX DEDUCTION?

Consult your tax advisor to be sure. Generally, the following formula applies:

		example	your home
original purchase price of home:		$ 70,000	$______
plus substantiated improvements after purchase:	+	$ 15,000	$______
total cost:		$ 85,000	$______
minus balance of 1st mortgage:	−	$ 50,000	$______
Maximum deductible home equity loan:		$ 35,000	$______

HOME EQUITY LOANS ARE AN IMPORTANT FINANCIAL TOOL FOR CONSUMERS

THEY OFFER MANY BENEFITS

- **CONVENIENCE**—The revolving line feature and the higher credit limit on home equity loans gives consumers the ability to accommodate most of their lending needs on their own, thereby avoiding repeated visits to the bank. Money can be accessed with a check, coded telephone call or credit card.
- **COMPETITIVE RATES**—Home equity loans may offer borrowers more competitive rates than other consumer loans. This can be particularly true at the beginning of the loan term, when a low "introductory rate" may be in effect for a specified period. (But don't be mislead by introductory rate offers which usually apply for a temporary period.) Additionally, the variable-rate feature of home equity loans offers consumers a chance to get the best affordable interest rate in times of low market rates. Of course, consumers must keep in mind that payments may increase if market rates rise.
- **LIQUIDITY**—A house is a valuable, non-liquid asset. A home equity loan offers consumers a way to tap dormant equity by converting part of that built-up equity into personal cash flow.
- **TIME**—A home equity loan offers a longer repayment term than conventional consumer loans, which can be an added benefit for disciplined consumers.
- **TAX ADVANTAGES**—Some interest payments on home equity loans are still deductible, even though Congress will phase out other consumer loan interest deductions by 1991. Generally, interest is deductible up to the original purchase price of the home (not market value) plus substantiated improvements. The rules vary for educational and medical uses and for home loans financed before August 16, 1986. Ask your tax advisor if you're eligible for a deduction.

HOME EQUITY LOANS SHOULD NOT BE USED TO COVER CURRENT LIVING EXPENSES OR TO INCREASE YOUR STANDARD OF LIVING BEYOND YOUR MEANS.

Bankers recommend that these loans be used for **major** purposes such as home improvement, education, medical expenses, and prudent debt consolidation.

BUT KEEP IN MIND PITFALLS

- **DEBT OVERLOAD**—Can you take on additional debt? If you are a two income family, could you meet payments if one family member loses a job? Don't risk the equity in your home—make sure you borrow only what you need **and** what you can pay back in a reasonable time period. Remember, if you should have to sell your house because of a relocation or any other reason, it might not be wise to secure a loan with the equity in your home.
- **VARIABLE RATES WITH NO LIMITS**—Many home equity loans don't have limits on how high rates can go. Those who are uncomfortable with this potential risk may consider a fixed-rate loan or find a variable-rate equity loan that has an interest rate cap.
- **INTEREST-ONLY PAYMENTS**—Think twice about interest-only payments. They encourage perpetual debt and you may be faced with a large balloon payment at the end of the loan.
- **TEMPTATION TOWARD FRIVOLOUS SPENDING**—Home equity loans have been blamed for encouraging unnecessary spending, but ultimately it's the consumer's responsibility to exercise financial discipline. Generally, a home equity loan should not be used for current living expenses or for something that will depreciate in value over time.
- **AGGRESSIVE LENDERS**—Banks and other traditional lenders have years of prudent lending experience and are generally responsible loan providers. But beware of aggressive home equity loan marketing, especially from non-traditional lenders who may cut corners, skip thorough appraisals, provide only minimum information on loan terms, and make inappropriate loans.
- **FORECLOSURE RISK**—Remember, home equity loans are secured by a major asset—your home! If you are suddenly unable to meet loan payments, many bankers will help you devise an alternative payment schedule until you get back on sound financial ground. In the future, foreclosure is likely to be a feasible, but rare occurence.
- **CLOSING COSTS**—Like any other mortgage, a home equity loan has up front costs that may cover application processing, appraisals, title, insurance, attorneys and mortgage recording. Some equity loans also have annual fees.

TESTIMONY OF

H. EARLE FERGUSON
THE CONSUMER BANKERS ASSOCIATION
BEFORE THE SUBCOMMITTEE ON CONSUMER AFFAIRS
OF THE
BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
UNITED STATES SENATE
CONCERNING HOME EQUITY LENDING

November 18, 1987

Mr. Chairman, members of the Subcommittee, I am Hef Ferguson, Senior Vice President of Crestar Mortgage Corporation, headquartered in Richmond, Virginia. I am appearing today on behalf of the Consumer Bankers Association (CBA).[*] Both individually and on behalf of CBA, I want to thank this Subcommittee for the opportunity to testify on the subject of home equity lending generally, and to address certain legislative and regulatory initiatives on that subject.

The CBA position is a very simple one. Home equity loans and lines of credit are proving to be among the most popular and useful financial products in a generation. They afford consumers financial liquidity and flexibility never before possible. Available evidence indicates that consumers are using them prudently. Similarly, lenders are providing these services with due regard to both commercial reason and consumer interests. Home equity credit is already subject to significant regulation, both as to disclosure and as to terms and practices, and further regulatory proposals are being considered at the Federal Reserve Board.

We believe that overly restrictive new legislation on home equity credit is unneeded. We ask that congressional consideration be limited to modifications of the existing disclosure scheme, such as are proposed in H.R. 3011 introduced by Congressman David Price of North Carolina. We also note that the staff of the Federal Reserve Board is developing a parallel package of recommendations on this subject that should be considered before congressional action is undertaken. In summary, we respectfully submit that our testimony will show that present circumstances warrant nothing more than the earlier disclosure of essential credit shopping information.

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[*] The Consumer Bankers Association was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 700 federally insured banks, savings and loans and credit unions that hold more than 80 percent of all consumer deposits, and more than 70 percent of all consumer credit held by federally insured depository institutions.

I. Many Perceptions Concerning Home Equity Lending Are Inaccurate

Initiatives to impose substantive restraints on home equity lending practices, such as are contained in H.R. 3468 introduced by Congressman Schumer, are based on a number of erroneous perceptions. These range from misunderstandings of the nature of open-end lending practices in general and home equity loans in particular, to outright mistakes and mischaracterizations concerning the requirements of existing state and federal disclosure, contract and consumer protection laws.

They also evidence a pervasive bias that must be laid to rest immediately. That is the notion that home equity borrowers and lenders together are bent on rushing blindly and even irresponsibly toward the brink of financial ruin. This notion is totally unsupportable when one reviews current consumer usage patterns, delinquency and default rates, and industry credit granting practices, educational efforts and foreclosure experiences.

It is important to focus on the essence of the home equity line of credit (HELC) relationship. Consumers, already experienced in purchase money mortgage financing, gain further access to their own assets. Lenders, having identified the characteristics of stability and maturity that define the ideal lending risk and the core of a desirable customer base, commit to honor substantial credit requests at favorable interest rates, on an extended, open-ended basis. The nature of this clientele and commitment render unrealistic the assertions that lenders would act in an arbitrary or capricious manner with respect to such loans. They would promptly alienate their best present and prospective customers in the process.

Further, this relationship is consummated only after the lender gives detailed contractual and Truth-in-Lending disclosures and only after the consumer declines to cancel the deal during a three-day cooling-off period provided by federal law. In short, this is a popular, pro-consumer financial service entered into with foreknowledge and deliberation by a financially experienced borrowing public.

The demographic profile of this HELC service underscores these points. During the spring of 1987, the Survey Research Center (SRC) of the University of Michigan studied the subject on behalf of the Division of Research and Statistics of the Board of Governors of the Federal Reserve System. In the summer of 1987, the Center for Financial Services Studies of the McIntire School of Commerce at the University of Virginia conducted a vastly more detailed survey on the subject on behalf of CBA covering 302 financial institutions in 47 states. The results of each survey are strikingly similar where comparable questions were asked. Survey results are parenthetically referenced below by descriptive initials (i.e., SRC or CBA).

The average consumer borrower is between 35 and 49 years of age (CBA). The borrower's household income equals or exceeds $44,000 (CBA/SRC). That borrower has worked for the same employer for 8 years, owned a home for over 9 (CBA), and tends to be better educated than the average homeowner (SRC). Less than 10% of the households surveyed by SRC had either applied for or held a HELC. Finally, of the 80% of homeowners surveyed who acknowledged their availability, ninetenths indicated no intention of opening a HELC in the near future (SRC).

The maturity and deliberation of the borrowing public is further reflected in HELC usage patterns. The most frequently mentioned reason for borrowing was for home improvements (CBA/SRC). Debt consolidation was the second most frequently mentioned reason (CBA/SRC). About 5% of the financial institutions cited major purchases, personal investments or educational expenses as the most frequent uses of borrowed funds (CBA). Finally, 31% of HELC borrowers indicated no account usage to date, more than half reported no use in the preceding six months and one-fifth had used their accounts just once (SRC).

Creditors surveyed substantiated this sobriety in usage patterns. The average creditor held $11,800,000 in approved lines but only $6,800,000 in actual HELC outstandings (CBA). Only one-fifth of all home equity borrowers surveyed indicated that they had used more than half of their credit line (SRC). Creditors offering variable rate HELCs indicate that their typical borrower has drawn down no more than 57% of the available credit line (CBA).

The deliberation and prudence with which borrowers approach HELC borrowing is matched by that of creditors granting those privileges. While the maximum loan-to-value ratio used by the average creditor is 76%, the average variable rate HELC is granted at a loan-to-value factor of less than 70% (CBA). In fact, this conservative ratio includes both first mortgage debt and the approved HELC (CBA). Further, if you look only at present outstandings (as opposed to approved HELCs), this factor shrinks to only 57% (CBA)! The effective result of these factors is that the average variable rate HELC equals less than 1/2 of the total home equity of the average homeowner (CBA).* We also note that over 70% of variable rate HELC approvals are based either on a full appraisal or municipal tax assessment (CBA). Finally, most creditors reported strict credit review procedures on at least an annual periodic basis after opening a HELC relationship (CBA).

Ultimately, the care and conservatism with which borrowers approach HELC usage and creditors address HELC lending is nowhere better reflected than in the low rates of HELC delinquency and foreclosure. The rate of HELC delinquencies is more than 30% less than that of all consumer credit (CBA). About 1% of all HELCs were delinquent (over 30 days) in 1986, as compared to 1.5% of all consumer debt (other than unsecured credit cards) (CBA). Inclusion of credit card delinquencies would expand this differential appreciably. Also, only 14 of the 302 institutions surveyed reported any foreclosures in 1986! This represented approximately 1.5 foreclosures per reporting institution.

This evidence suggests that consumers and creditors are treating the HELC relationship with the utmost respect and caution. Neither homeowners nor creditors are profligate with respect to the usage or provision of this consumer financial service. Substantive restrictions to protect homeowners from an alleged propensity for irresponsible behavior, whether their own or that attributed to the financial institutions with which they deal, are neither necessary or justifiable. No patterns of abuse can be documented at this time nor does the evidence suggest that they will be in the future.

In fact, in addition to prudent lending practices, HELC providers have taken a further pro-consumer stance by providing credit-shopping and educational guidelines to both their financial services colleagues and to consumers generally. Consumer education pamphlets and shopping guides have been produced and disseminated nationwide.

CBA itself has produced a consumer pamphlet for its members to use. It has met with unparalleled demand (an excerpt is attached as Appendix A). To date, CBA has given several thousand copies of the brochure directly to consumers across the country, pursuant to requests generated by related publicity. In addition, CBA has issued approximately 100,000 copies to its members as a customer relations tool. CBA has also made camera-ready copies available to more than a dozen members for in-house reproduction and dissemination. One such CBA member plans a public distribution of 50,000 customized pamphlets.

The pro-active efforts underscore the industry's commitment to the responsible and informed usage of HELCs. These efforts refute directly consumerist charges of reckless promotions centering on inducements to luxury or frivolous expenditures.

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* The appraised value of the average house was $84,975, and the outstanding balance on the first mortgage was $34,989, leaving average total available equity of $49,986 (CBA).

Similarly, they refute related charges of insufficient HELC disclosure and shopping information. Consumers simply have not found there to be a lack of HELC information in the marketplace. More than 90% of the HELC account holders interviewed by SRC reported that they had received all of the information they needed before they opened their HELC. More than 35% of those account holders said that they had considered an alternative source of credit, a clear indicator of comparison shopping capability and one that accords with Federal Reserve studies of actual credit shopping experience for all forms of consumer credit.*

This is not to say that improvements in the disclosure area cannot be made. However, based on the analyses of consumer usage patterns, delinquency and default rates, and industry credit granting practices and educational efforts, we submit that there is simply no evidence of need for the imposition of substantive restrictions on HELC practices.

II. New Disclosure Scheme Must Be Simple, Consistent With Existing Law And Not Redundant

If Congress deems it necessary to provide for additional consumer protection in this area, it should be limited to the types of application stage disclosures proposed in H.R. 3011 by Congressman Price. We firmly believe that the kinds of intrusive, substantive restrictions proposed by Congressman Schumer in H.R. 3468 are neither necessary nor warranted at this juncture.

In particular, CBA must state its strong and unwavering opposition to any efforts aimed at imposing specific pricing restraints on HELC practices. Whether framed as interest rate caps, loan-to-value ratios or overly restrictive initial discount, rate change or call limitations, they would prove harmful to consumers, by limiting HELC availability to a select few of the least risky customers. Specific artificial pricing restraints would also have an anticompetitive effect on the HELC marketplace, forcing creditors out of the market and acting as a disincentive to remaining HELC providers to respond to market forces dictating varied terms beneficial to consumers.

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* For example, see the Annual Percentage Rate Demonstration Project, Board of Governors of the Federal Reserve System, March 1987, p 29.

For these and other reasons, Congress has never passed specific interest rate or other pricing restrictions for consumer credit,* electing instead to provide for the timely dissemination of credit shopping information to consumers. Congress has trusted the free market to regulate prices. We respectfully urge that Congress not deviate from this well-reasoned and time-tested approach.

Subject to certain modifications, the Price bill would compliment the traditional congressional approach to this issue. It seeks to provide consumers with key credit terms at an early stage of the lending relationship without imposing undue burdens on creditor operations. As mentioned above, existing law already requires that consumers be given comprehensive disclosures and a three-business day right to cancel the account relationship before they can access an HELC. So the question is what additional disclosures should be given to consumers.

In answering this question, some guiding principles must be kept in mind. First, Congress must be wary of duplicating the detailed information required by existing law.** A corollary to this principle is the need to keep additional disclosures simple. Finally, the detailed initial disclosure and right of rescission formulas in present Truth-in-Lending law must not be disturbed.

The Price bill largely incorporates these principles by focusing on important HELC features and opting for their conspicuous, segregated disclosure at the application stage.

At Appendix C of this testimony, CBA has recommended for your consideration further refinements to H.R. 3011 which are consistent with its objectives and would facilitate the practical operation of this early disclosure scheme. These recommendations in most instances address issues generic to any scheme of additional disclosures in this area. Accordingly, they may constitute a useful point of reference for this Subcommittee's members and staffers.

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* Section 1204 of the recently enacted Competitive Equality Banking Act of 1987, P.L. 100-86, contains an interest rate cap requirement for all variable rate loans secured by one-to-four family dwellings but does not provide for a specific limitation.

**These requirements are reviewed at length in Part III of our testimony.

III. There is a Wealth of Existing Disclosure Law and Consumer Protections

Should Congress elect to provide for additional disclosures in this area, it is imperative tha the new requirements be framed with due consideration of the vast array of federal and state consumer protection laws presently applicable to home equity credit. Consideration must also be accorded to regulatory movement to fine-tune those laws which is presently underway.

Let us review briefly the major existing constraints, to show how much discipline already exists in the home equity credit market.

A. Just this past July, Congress mandated -- in Section 1204 of the Competitive Equality Banking Act of 1987 (P.L. 100-86) -- that creditors must include interest rate caps in all variable-rate, dwelling-secured consumer credit transactions. This includes conventional closed-end second mortgages, as well as the more recent pattern of HELCs secured by the consumer's home.

In its proposed regulations to implement that law (52 FR 34811, September 15, 1987), the Federal Reserve Board has taken a broad view of the legislative intent. For example, the proposal covers fixed-rate transactions if the creditor reserves the right to change terms as well as transactions with explicit rate adjustment features. Thus one suggested weakness of home equity credit -- the absence of contractual rate limitations -- will soon disappear. And if creditors now must include rate caps in the contract, they can be expected to compete for customers by offering more favorable limitations.

B. The federal Truth-in-Lending Act (TILA)* contains a time-proven regimen for advertising about home equity credit. TILA also requires detailed sets of transactional disclosures that reflect the differences between closed-end and open-end credit formats, and between variable-rate and fixed-rate terms. In open-end transactions in particular, consumers receive disclosures before the account is opened, and periodic reminders of the status of the account, balances owing, payments due, and applicable rates and terms. The TILA initial disclosures must include "clear and conspicuous" references to any security interest and to the property serving as collateral. The chart attached as Appendix B details all of these disclosure requirements.

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* 15 USC 1601 et. seq.

Not only do home equity credit consumers receive extensive disclosures, but home equity transactions are subject to the right of rescission. This means that a consumer having second thoughts about the transaction can cancel it at no cost within 3 business days. This right of rescission was originally included in the Truth in Lending Act of 1968 precisely to protect consumers from unwitting or improvident encumbrances on their homes, which is the newly expressed concern about home equity credit. In this regard, the law anticipated the problem by nearly twenty years.

Truth-in-Lending has been a dynamic law, and the Federal Reserve Board has not hesitated to adjust the rules where necessary to deal with new practices. The Board is monitoring home equity credit practices carefully and has stated its concerns as to the need for regulatory strengthening in this area. In response, the Board staff has indicated that a comprehensive proposal for new home equity disclosures under Regulation Z will be presented to the Board in early December, 1987.*

The TILA rules on disclosure and rescission are reinforced by state disclosure laws (that may expand the terms to be disclosed), and by federal and state laws prohibiting false advertising and deceptive and unfair practices. Finally, the basic tenets of contract law require the lender to explicitly state its rights in the loan agreement.

In short, consumers have ample opportunity under existing law to learn the details of the transaction, and to consider cancelling it. While keeping an open-mind on initiatives like the Price bill, we must point out that refinements in these rules are being addressed and may be accomplished at the regulatory level without new legislation.

C. Other explicit federal law may enhance the protection of consumers entering into home equity transactions. For example, savings institutions offering variable rate credit under regulations of the Federal Home Loan Bank Board (12 CFR § 545.33 (1987)) already provide multi-page disclosures, and the Consumer Handbook on Adjustable Rate Mortgages, at the time of the consumer's application. These disclosures constitute a full exposition of a creditor's HELC plans, their terms, and their arithmetic. These FHLBB regulations also control substantive provisions in the home equity transaction, such as rate caps, change intervals, permissible indexes, and the like.

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* At an open meeting of the Board of Governors of the Federal Reserve System on November 5, 1987, the Board staff indicated that they were presently refining on a package of proposed amendments to the open-end credit provisions of Regulation Z specifically dealing with home equity lending. This work was undertaken at the request of both the Board and the Board's Consumer Advisory Council. Balloon payments, acceleration or call provisions, and payment schedule disclosures are some of the subjects to be covered by the package of proposed amendments.

D. Consumers in home equity transactions may realize further substantive protections under state law. The exact content of state law will vary from jurisdiction to jurisdiction, but the states frequently legislate or regulate concerning such matters as --

- o Interest rate ceilings (usury laws);
- o Caps on the frequency and amounts of rate and payment adjustments in variable rate transactions;
- o The right to pay off prior balances, or to refinance a balloon payment, at the original rate;
- o Limitations on a creditor's right to declare default, accelerate balances, confess judgments, or foreclose on collateral (cf. Uniform Commercial Code §1-208; Uniform Consumer Credit Code §§ 5.109, 5.110);
- o Maximum repayment schedules and restrictions on negative amortization; and
- o Mandatory lead times for changes in the terms of open-end credit plans (cf. Uniform Consumer Credit Code §3.205).

At the very least, any new federal initiatives should be crafted with due consideration of this substantial body of related state law protections.

In sum, we urge Congress to narrowly frame any new most focused of legislative initiatives lest it duplicate existing law, and unnecessarily complicate transaction paperwork, increase creditor compliance costs, and stifle marketplace developments.

IV. Summary Concerns

As the Subcommittee proceeds with its review of home equity credit, CBA must clearly object to certain restrictive approaches that have been publicly discussed and/or proposed in recent weeks including those contained in H.R. 3468.

A. We believe it inadvisable to legislate sweepingly in an area that is in such a state of flux and development as home equity lending. Today's speculation about problems does not always become tomorrow's reality. We have seen no

evidence of creditor overreaching or consumer abuse. In fact, the impression is unavoidable that creditors are competing vigorously, imaginatively and responsibly, and that consumers are responding with enthusiasm and a good measure of prudence.

We ask Congress to exercise some caution before imposing new requirements on transactions that are saturated with disclosures and consumer protections under time-tested Truth-in-Lending rules. At the very least, Congress should give the Federal Reserve Board the maximum opportunity to address home equity lending at the regulatory level, a process already underway, before carving new legislative stone.

Congress should be especially hesitant to take action on the basis of an incomplete record that would have the perverse effect of limiting for consumers their access to the liquidity in their home equity. Burdensome regulation increases creditor costs, which must be recouped from customers. Stringent restrictions on contract terms are a disincentive for creditors to offer that product, at least on a readily affordable basis. Informed consumers vote with their feet -- they choose or reject financial services based on their perceptions of costs and benefits -- and they have shown a strong disposition to choose home equity credit. We question the wisdom of pre-mature and ill-advised "preventative" action that would curtail that choice.

B. Much publicity has been given to the notion of "rate rise surprise." The concerns expressed are in fact objections to variable rate credit in any form, not just in home equity transactions. Adjustable rate credit is now well established and accepted, by credit extenders and borrowers alike. Rate caps are now required by law to be incorporated into the contract, and both federal and state rules may restrict rate ceilings, rate adjustments, and payment-schedule changes. The Federal Reserve Board has published proposals for revamping disclosures in adjustable rate purchase money mortgages. The policing of adjustable rate credit is already occurring and needs no special legislation for home equity transactions. Artificial (and arbitrary) rate caps, mandatory time limits and intervals, prohibitions on rate floors -- these are ingredients of direct rate regulation, and ultimately of consumer credit allocation, subjects that Congress has properly avoided.

C. Closed-end, purchase money mortgage regulations of the various federal regulatory bodies have been cited by analogy to justify similar kinds of substantive restraints on HELCs. There is, however, a fundamental distinction between purchase money mortgage loans and HELCs that renders such analogies erroneous. Purchase money mortgage loan proceeds are necessarily larger and are advanced to the borrowers at closing while HELC's lie dormant for long periods and are seldom drawndown completely. A purchase money lender is therefore assured of at least some profit up to the point at which pricing or other restrictions kick-in. In contrast, the HELC lender will see neither the magnitude nor consistency of loan usage over the life of an HELC relationship. Theoretically, the HELC lender could never see a dime of interest profit. Worse, the HELC lender may see the greatest account usage only at the point in which pricing and related restraints begin to operate, i.e., when market conditions have made other loans more expensive or difficult to obtain.

To suggest then that purchase money mortgage loan limitations are appropriate for HELCs is to ignore the substantial differences in the purposes, uses and practices respecting these forms of credit. HELC requirements must be based soley on the realities of HELC lending.

D. Much has also been said of the potential for consumer abuse in home equity transactions that permit the creditor to terminate or "accelerate" at will, confronting the consumer with a frozen credit line, or a large balloon payment, or even foreclosure on the home. We simply do not believe that this is a problem of any substance. For one thing, we do not know how widely such clauses are used in home equity credit, and have seen no data on it. More importantly, some forms of acceleration or termination-at-will clauses have been standard provisions in credit transactions for many years; they are a necessary precaution against the debtor's nonpayment or other default. Without a provision permiting the creditor to call the entire debt due in the instance of default, the creditor would be forced to separately sue on each installment as it fell due. This would present impossible financial and administrative burdens for lenders, debtors and the courts alike. We would also note that there is a well-established body of state law to discourage precipitous or bad faith exercise of this essential legal tool.

Aside from legal restrictions, it is rarely in the creditor's own interest to misuse such a clause. If the consequence is that the consumer defaults on the balloon obligation, the creditor must either initiate foreclosure (an inherently unattractive prospect given the second mortgage status of the HELC creditor), or refinance the obligation itself. The refinancing is generally subject to the same controls, as to rate and other terms, as the original transaction. Abusive exercise of a termination clause is, above all, poor public relations for any financial institution.

We do not suggest that additional limitations in this area, if grounded in commercial reason, cannot be effected. But we would again remind the Subcommittee that the Federal Reserve Board has recently solicited comments on the operation and effect of termination clauses, and is preparing to propose disclosure rules on them. This suggests first that Congress need not rush to fill a consumer protection void, and second

that any remedial measures found needed may be capable of accomplishment by Board regulation without new legislation.

E. Suggestions that federal law should set maximum loan-to-value ratios for home equity credit would so deeply intrude the Congress into the substantive terms of consumer transactions as to deprive consumers of access to a portion of their home equity. A consumer needing or wanting to liquidate that equity could sell it, but could not borrow against it! In addition, the creditor is most likely to exercise self-discipline in setting a realistic loan-to-value ratio in order to protect it's investment. The CBA survey clearly reflects that conservatism prevails in this respect.

F. Finally, we must express certain concerns as to the proposed expansion of Truth-in-Lending law beyond the bounds of its original purposes and congressional intent. Many of the initiatives under discussion today propose substantive limitations on the nature of the debtor-creditor relationship. These include pricing restraints, mandatory time limits and intervals, secondary market protections and other restrictions that differ in kind from the disclosure objectives of TILA.

Our point is more than a legal purist's objections to this less than subtle alteration of TILA. Our concern is that a federal statute framed with due regard for the sovereign authority of the states to substantively regulate consumer contract law may now become a vehicle for trampling that authority. We are troubled by the substantial expansion in scope of a statute which has in the past been construed in a very strict and hypertechnical fashion. We are concerned lest a law, whose substantial punitive penalties were justified by its narrow focus on relatively simple matters of form, is to be converted into a sanction for far less easily defined matters of conduct.

In short, CBA views the expansive thrust of many of the initiatives under consideration today with some degree of alarm. These initiatives would substantially alter a complex but fairly well-understood body of law designed for other purposes. They would go a long way towards establishing a federal contract law, a result Congress has assiduously avoided to date. To the extent that this becomes the ultimate congressional objective, CBA respectfully submits that it should be effected as a stand-alone proposition, with its own set of well-considered remedial measures and its own separate and clearly defined legislative history. The complex but fairly well-settled body of Truth-in-Lending law and regulation should not be bent to serve these new and unintended purposes.

V. Conclusion

The Consumer Bankers Association is proud of it's record of supporting well-drafted legislation to improve the flow of information to consumers and to prohibit truly abusive and anti-competitive practices. We share some of Congress' concerns about the rapid growth of home equity credit, and have taken the lead in our industry to study that growth, and to educate our members and the public about possible problems.

We believe the evolving picture of home equity credit needs watching, and that those transactions may need further regulatory refinements. A process toward those ends is underway at the Federal Reserve Board, and we suggest the Subcommittee closely monitor that activity. If the record of these hearings justifies it, we would support some sharply focused statutory disclosure rules for home equity transactions, similar to those proposed by H.R. 3011 and as modified by the recommendations outlined in the Appendix to this testimony.

Mr. Chairman, members of the Subcommittee, I want to again thank you for the opportunity to appear today on behalf of CBA. I would be pleased to respond to any quesions you may have.

Senator DODD. Thank you very much.
Mr. Harman.

STATEMENT OF THOMAS D. HARMAN, VICE PRESIDENT AND GENERAL COUNSEL, MERRILL LYNCH EQUITY MANAGEMENT, INC.

Mr. HARMAN. Mr. Chairman, I am Thomas D. Harman, vice president and general counsel of Merrill Lynch Equity Management, Inc., in Stamford, CT. It is a pleasure to provide you with Merrill Lynch Equity's thoughts on home equity lines of credit.

Merrill Lynch Equity is a subsidiary of Merrill Lynch & Co., Inc. It began offering home equity lines of credit in California in the summer of 1982. Since then, Merrill Lynch Equity has grown into one of the largest issuers of home equity credit lines, nationwide. Merrill Lynch Equity currently offers home equity credit lines to consumers in 39 States and the District of Columbia.

In the period of over 5 years during which Merrill Lynch Equity has been offering home equity credit lines, Merrill Lynch Equity has observed few consumer problems, in connection with this product. The product has been very well received by consumers.

To date, Merrill Lynch Equity has received over $3.3 billion in applications for equity credit lines, and has extended over $1.6 billion in credit lines. Merrill Lynch Equity has avoided marketing gimmicks such as "teaser" rates. We qualify applicants for credit by determining whether their income will support their monthly payments, even at significantly higher interest rates. As a result of these factors and Merrill Lynch Equity's stringent underwriting guidelines, our foreclosure experience has been very favorable. To date, approximately one in a thousand of the credit lines which we have established has been terminated by foreclosure, and foreclosure is pending on only an additional one in a thousand of the credit lines.

Merrill Lynch Equity brings this product to the public's attention through limited advertising and direct mail programs. In addition, Merrill Lynch financial consultants counsel those of their clients who might be suitable candidates for, and benefit from, home equity credit lines. The financial consultants advise Merrill Lynch Equity of clients who desire to apply for equity credit lines.

Credit decisions are based both upon the applicant's verified income, resources and credit history, and upon the appraised value of the applicant's house and the outstanding balance of any first mortgage.

TWO AREAS THAT RAISE QUESTIONS

Two areas of equity credit line lending which have raised questions in the past are the lender's right to change the terms of an equity credit line after it has been established, and the lender's right to cancel an equity credit line and to require that it be paid in full, prior to its stated maturity.

As Congressman Price mentioned in his testimony, the loan documents used by Merrill Lynch Equity throughout the country require that, if Merrill Lynch Equity desires to change the credit line terms after the credit line has been established, Merrill Lynch Equity must give the borrower advance notice of any proposed change. If the borrower does not wish to accept the proposed change, the borrower can draw down as much of the credit line as he or she desires within a specified time frame, and then notify Merrill Lynch, in writing and within the specified time frame, that the borrower does not wish to accept the change. A borrower who does not wish to accept a change in terms may not draw down any more funds on the credit line after the borrower rejects the change, but the funds outstanding will continue to be governed by the original terms.

Merrill Lynch Equity's credit documents provide that the term of the credit line is 10 years. The documents do not give Merrill Lynch Equity the right to terminate the credit line before the expiration of the 10-year period, unless the borrower defaults on his or her obligations under the documents, or unless laws which become effective after the date that the equity credit line is established significantly impair the operation of Merrill Lynch Equity's equity credit line program. An example which comes to mind of a law which might have this effect is a State law which reduced the usury limitation below the lower of Merrill Lynch Equity's interest rate cap or the usury limitation which was in effect when the credit line was established.

Accordingly, Merrill Lynch Equity could not terminate its equity credit line solely because a consumer financial situation deteriorated or the customer became unemployed. It is true that if a consumer defaults on a home equity credit line, the lender may begin foreclosure proceedings, which could lead to the loss of the consumer's house. In analyzing this potential scenario, it is important to bear in mind that the same result could occur if a borrower who was a homeowner defaults on a substantial "unsecured" loan or line of credit. This is because the lender would probably obtain a judgment against the borrower, file a judgment lien against the borrower's house, and execute on the judgment lien. Responsible lenders follow work-out and credit counseling procedures to avoid foreclosure.

Merrill Lynch Equity supports full and fair disclosure to borrowers and potential borrowers in connection with all consumer credit transactions. Such disclosure enables the potential borrower to compare the various types of credit available, and to be informed of the basic terms of the available credit before being irrevocably obligated on the relevant credit instruments.

In general, Merrill Lynch Equity supports H.R. 3011 because it furthers the purpose of making full and fair disclosure to consumers regarding home equity credit lines, prior to the time that the consumers become obligated on a home equity credit line.

However, the disclosures required by this legislation, when combined with the disclosures already required, might result in such extensive disclosure, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures.

The chances of this adverse result to consumers occurring would be less if this legislation was revised so as to provide that the required disclosures were to be given in place of the disclosures required by other Federal or State laws and regulations.

Merrill Lynch Equity supports the goals which H.R. 3468 is intended to achieve, and the disclosure provisions of this bill. However, Merrill Lynch Equity is concerned about the requirements regarding the terms upon which lenders may offer equity credit lines. These requirements could result in all borrowers paying significantly more for home equity credit lines, and could prevent borrowers from obtaining home equity credit lines on terms which might be appropriate for particular borrowers' circumstances.

Merrill Lynch Equity feels that the free market and the demand of borrowers for various products should determine what features lenders offer in equity credit line loans. This same free market, driven by consumer demand, has resulted in the availability of a variety of types of conventional variable rate mortgage loans which are attractive to both borrowers and lenders.

Mr. Chairman, I would like to thank you for the opportunity to appear before your subcommittee today, and I would be happy to answer any questions which you might have.

[The complete prepared statement of Thomas D. Harman follows:]

6 Tips for Wise Use

By following these six guidelines, you can make wise use of your home equity line of credit:

1. Home equity credit is best used for *major expenditures* such as home improvements, children's college expenses, or major medical or emergency expenses. It can also be used to consolidate other debts at a lower interest rate. Because the equity in your home represents a substantial source of savings, it should not be used to finance current consumption such as food, clothing and entertainment.

2. Don't borrow more than you can afford to *repay over a reasonable period* of time. For instance, if you use your line of credit to pay for a car, pay it off as soon as you would pay off a regular car loan, usually over a period of three to five years.

3. *Interest only* payments are offered by some lenders, and may be appropriate when special circumstances may make it difficult or undesirable to pay down the principal, such as when children are in college. Generally, it's preferable to pay down principal to retire your debt.

With some plans, interest-only payments lead to a *balloon*, when the unpaid balance is due. This may be appropriate only for those who can predict that they can pay off their loan—perhaps because they plan to sell their home—or who are willing to refinance at the rate prevailing in the future. Be sure your income will be sufficient to qualify you for refinancing.

4. Total monthly payments on all types of loans should not exceed about *35 percent of your monthly before-tax income*. A good banker will help you determine how much debt you can afford.

5. Most home equity loans have a *variable interest rate*, meaning payments could fluctuate. Make sure you understand the terms and can afford the increase in the rate of interest if it should occur.

6. Interest payments on home equity loans *may* be fully tax deductible. *Consult a qualified tax specialist*, as each homeowner's situation is different.

Questions to ask your loan officer:

- Is a home equity line of credit most suitable for my needs, or would another kind of loan be more appropriate?
- What is the initial rate of interest? Is it fixed or variable? If it is variable, on what index is it based? How often can the rate change? Is there a cap or maximum increase in interest rate?
- What fees must I pay at the time of application and closing? Is there an annual fee?
- What will my minimum monthly payment be for each $10,000 in credit, and how much of the minimum payment will go to principal?
- If interest rates go up, will my minimum monthly payment go up with a variable rate loan? What increase in rate would cause my payment to go up?
- Are there circumstances under which my outstanding debt can increase if I only make the minimum payment?
- Are there conditions under which I can reduce my monthly payment? Will I still be paying down principal?
- Under what conditions can the bank demand repayment or refinancing of my outstanding credit? Can any of the credit terms be changed without my approval?
- Do I have an option of converting my line of credit into a fixed term installment loan to pay it off? If so, at what interest rate, and over what period of time?
- If my income or amount of available equity increases in the future, can I have my line of credit increased? Will I have to pay new fees? Will I have to requalify?

CBA
CONSUMER BANKERS ASSOCIATION
1300 N. 17th Street, Suite 1200, Arlington, VA 22209

What You Should Know About a Home Equity Line of Credi

APPEND

CBA
CONSUMER BANKERS ASSOCIATION

CURRENT HOME EQUITY [illegible]
DISCLOSURES REQUIRED BY
TRUTH-IN-LENDING ACT ("Act")/REGULATION Z ("Reg Z")*

Advertising (Act §143; Reg Z §226.16)

- o Must be accurate
- o Must reflect terms actually offered
- o Use of "trigger" term requires additional disclosures

  e.g. trigger terms:

  - o 17 % A.P.R.
  - o Small monthly service charge on remaining balance.
  - o $20 Annual membership fee buys you $2,000 in credit.
  - o No finance charge if you pay your full balance each month.

  "Required" additional disclosures:

  - o Any minimum, fixed, transaction, activity or similar charge that could be imposed
  - o A.P.R. and variable rate, if applicable
  - o Membership or participation fee

Initial Statement (Act §127; Reg Z §226.6)

(Written disclosures made to consumer before account can be opened)

- o Finance charge: explanation of charges, methods of computation, free ride periods, periodic and annual rates and when they apply
- o All other charges that may be imposed
- o Security interest description
- o Statement of federal billing and error resolution rights
- o 2 right of rescission** notices because credit plan is secured by consumer's dwelling (see Act §125; Reg Z §226.15)

Periodic Statements (Act §127; Reg Z §226.7)

- o Previous balance
- o Identification of each transaction during the period
- o Credits to the accounts
- o Periodic and annual rates
- o Balance to which finance charge is applied and how it is computed
- o Amount and components of finance charge
- o Actual A.P.R. for the period
- o Other charges itemized and identified
- o Closing date of billing cycle
- o New balance on that date
- o Free ride period
- o Address for notice of billing errors

Subsequent Disclosure Requirements (Act §122; Reg Z §226.9)

- o Statement of federal billing rights, at least annually
- o New credit devices/features added to plan must be disclosed prior to usage by consumer
- o A change in terms must be disclosed at least 15 days prior to effective date of change
- o Right of rescission and notices, whenever credit limit is increased (see Act §125; Reg Z §226.15)
- o Billing error resolution notices to consumers and others (see Act 170; Reg Z §§226.13(c), -(e) and -(g))

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* Act - 15 U.S.C §1601 et seq.
Reg Z - 12 CFR Part 226

** Consumer has 3 day right to cancel opening of account, i.e., 3 day "cooling off" period to review all terms of account agreement

APPENDIX C

Recommended Refinements to H.R. 3011

A. Limitation of the Application Disclosure Scheme to HELC's Secured by the Consumers "Principal" Dwelling. All other special protections accorded by the Truth in Lending Act to dwelling-secured credit transactions are limited to the consumer's principal residence or true household.[*] This also seems to be the focus of congressional concern here (rather than vacation or investment property). H.R. 3011 should reflect that focus by limiting its coverage to plans secured by a "principal" dwelling.

B. Inclusion of All "Generic" Information in the Federal Reserve Pamphlet. Section 3 of H.R. 3011 calls for the Federal Reserve Board to develop a consumer pamphlet describing general HELC lending practices and the potential advantages and disadvantages of HELC plans. Creditors are to distribute these pamphlets to consumers at the time of application.[**] We submit that some of the application stage disclosures called for under section 2(a) of the Price bill could be included in these pamphlets, thereby simplifying the application stage disclosure scheme. For example, interest only payment and change-in-terms features could be more briefly acknowledged in the segregated disclosure statement, where applicable, and discussed in the indicated detail in the pamphlet.

C. Limitation of "Conspicuously Segregated" Disclosure Requirement to Application Stage Disclosures. Section 2(a) of H.R. 3011 calls for the "conspicuous segregation" of the new HELC disclosures from other information provided in connection with the HELC plan. Since these new disclosures may also be required in connection with the initial Truth-in-Lending disclosure statement, there should be a clarifying limitation to the effect that this segregation requirement applies solely to the application stage. This would greatly reduce compliance burdens by eliminating the need for massive revisions to now standardized initial disclosure statements. Such a limitation would in no way undercut the bill's early disclosure objectives.

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[*] E.g., right of rescission, 15 USC §1635

[**] As presently framed, section 2(a) of H.R. 3011 could require such distribution at both the application and account-opening stages, a needless redundancy. The latter distribution requirement should be deleted.

D. Modification of APR Disclosure Requirement. Section 2(a) of H.R. 3011 calls for disclosure of the APR ". . . which will be in effect when credit is first extended . . ." Since many of these plans lie "dormant" for long periods after they are opened, this reference point is unknowable and the disclosure requirement should be modified accordingly. Disclosure of a nominal interest rate applicable at or near the time the HELC was opened might suffice.

E. Provision of Disclosures Should be Triggered by Receipt of a "Written" (or otherwise "Completed") Application; Sending of Disclosures Within Three Business Days Following Phone or Mail Applications Should Suffice. The full panoply of Truth in Lending civil sanctions would apply to a failure to comply with H.R. 3011's application stage requirements. Failure to provide these disclosures to persons making purely casual inquiries or failure to insure that disclosures are actually received by telephone or mail customers within 3 business days should not carry such severe penalties.[*]

F. The Advertising Requirements in Section 2(c) of H.R. 3011 Largely Duplicate Section 143 of the Truth in Lending Act and Should be Eliminated or Substantially Reduced. Proposed new TILA section 147(a) largely restates existing TILA section 143 and is, therefore, redundant. We note also that existing sections 105 and 143 give the Federal Reserve Board broad authority to require additional open-end disclosures. Since the Board staff is already in the process of promulgating such recommendations, we urge Congress to consider those initiatives before acting in this area. Finally, the prohibition of references to "prime" in HELC account offerings seems excessive -- many HELC plans are literally indexed to prime rates and TILA disclosure would be difficult if not impossible without a reference to prime. Further, some HELC plans may carry proprietary labels using the word "prime". Board authority to restrict trade or service mark usage of this sort is unclear at best.

G. Uniform Federal Disclosure Rules Are Important. The disclosures required by H.R. 3011 should establish uniform credit shopping standards, and should be comparable wherever the creditor or consumer is located. To ensure this objective, CBA recommends the inclusion of language clearly preempting the states from enacting different or additional disclosure requirements in connection with HELC applications. This approach has been adopted already in this session by the House Banking Committee with respect to credit card application disclosures (H.R. 515). To our knowledge, no existing state laws have addressed application stage HELC disclosures, thus Congress would be acting only to keep the slate clean of potentially conflicting requirements and would not be intruding in an area of existing state law.

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[*] Some consideration might be given to moving the Fed Pamphlet requirement into Truth in Lending's advertising rules (§ 143) if the goal is to provide earlier credit shopping information. The advertising rules do not incorporate Truth in Lending civil sanctions. Creditors would be more inclined to disseminate information freely in the absence of the threat of civil liability.

H. Additional Compliance Lead Time Is Necessary. H.R. 3011 provides only six months for regulatory implementation of extensive Truth-in-Lending amendments. Truth-in-Lending changes are currently effected on an annual basis providing for six months between the completion of final rulemaking and required compliance. We therefore suggest an extension of H.R. 3011's effective date to at least nine months after the date of enactment.

Statement of
Merrill Lynch Equity Management, Inc.
On Home Equity Lines of Credit
Presented by
Thomas D. Harman
Vice President and General Counsel
Before the
Subcommittee on Consumer Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate

November 18, 1987

Mr. Chairman and members of the Subcommittee, I am Thomas D. Harman, Vice President and General Counsel of Merrill Lynch Equity Management, Inc., in Stamford, Connecticut. It is a pleasure to provide you with Merrill Lynch Equity's thoughts on home equity lines of credit.

Merrill Lynch Equity is a subsidiary of Merrill Lynch & Co., Inc. It began offering home equity lines of credit in California in the summer of 1982. Since then, Merrill Lynch Equity has grown into one of the largest issuers of home equity credit lines, nationwide. Merrill Lynch Equity currently offers home equity credit lines to consumers in 39 states and the District of Columbia.

You have asked us to comment on problems the consumer faces in dealing with home equity credit lines, how Merrill Lynch Equity handles equity credit lines, and what legislation, if any, Merrill Lynch Equity feels should be enacted. You also asked us for our reaction to Congressman Price's bill, H.R. 3011, and to Congressman Schumer's bill, H.R. 3468.

Problems faced by Consumers in Dealing with Home Equity Credit Lines

In the period of over five years during which Merrill Lynch Equity has been offering equity credit lines, Merrill Lynch Equity has observed few consumer problems, in connection with this product. The product has been very well received by consumers.

To date, Merrill Lynch Equity has received over $3.28 billion in applications for equity credit lines, and has extended over $1.6 billion in credit lines. Merrill Lynch Equity has avoided marketing gimmicks such as "teaser" rates (low initial interest rates which revert to a higher rate after a brief time period). We qualify applicants for credit by determining whether their income will support their monthly payments, even at significantly higher interest rates. As a result of these factors and Merrill Lynch Equity's stringent underwriting guidelines, our foreclosure experience has been very favorable. To date, only about one in a thousand of the credit lines which we have established has been terminated by foreclosure, and foreclosure is pending on only an additional one in a thousand of the credit lines.

Merrill Lynch Equity feels that it is very important that consumers be aware of both the advantages and disadvantages of obtaining home equity credit lines, so that a consumer can make an informed decision as to whether a home equity credit line is appropriate for the particular consumer, and, if so, which of the many types of home equity credit lines offered is most appropriate for the particular consumer's needs.

Although lenders have offered loans secured by borrowers' houses for many years, home equity credit lines offer a number of advantages to the consumer, over more traditional sources of credit. The major advantages of home equity credit lines for the consumer include the following:

1. Home equity credit lines offer the borrower a great deal of flexibility in credit management. They allow the borrower to closely manage his or her credit by borrowing (and paying interest on) only the exact amount that he needs at any time. For example, if a borrower were to use a conventional second mortgage loan to finance a college education or construct an addition on his or her home, the borrower would need to draw down (and pay interest on) the entire loan amount when the borrower established the loan, even though the bills for the education or the home improvement would be presented over a period of months or years. Furthermore, with a home equity credit line, a borrower can pay additional principal in months when the borrower has more income, thus reducing the principal balance on which the borrower has to pay interest, and pay only the minimum amount due during months when the borrower has less income. In addition, an equity credit line borrower who has repaid some of the principal balance will still have access to additional credit.

2. Home equity credit lines provide the consumer with a very convenient source of credit which allows the consumer to keep his or her personal business personal. Once the consumer's application has been approved and the consumer has established a line of credit, the consumer may draw down as much credit as he or she desires up to the consumer's credit limit, without filing a new application and revealing further personal and financial information to the lender, prior to each need for credit. Access to credit is as convenient for the borrower as writing a check.

3. Home equity credit lines offer qualified borrowers access to substantial amounts of credit, for personal and business needs.

4. Because home equity credit lines are secured loans, lenders can often charge less interest on these loans than on other types of loans (such as credit cards and unsecured personal loans).

The potential disadvantages of home equity credit lines include the following:

1. Consumers for whom home equity credit lines might not be the most appropriate source of credit may obtain home equity credit lines. Merrill Lynch Equity feels that the best way to alleviate this potential problem is to assist in efforts to educate consumers as to the advantages and disadvantages of various sources of credit. Fortunately, a great deal has been written in the popular press recently, regarding the advantages and

Senator DODD. Thank you very much. I thank all three of you. I'm not going to keep you long because there's another vote on, but I understand I have about 20 minutes to get there, so I'm going to ask some things that I was going to sit here and go over with you in detail, but I think what I will do with a couple of these things is to ask you to maybe submit some things.

One is to the ABA. Let me commend the ABA for your kit you're putting together. I think that's creative. It's getting ahead of the curve. I think it's helpful and it might be worthwhile if you could just submit to the committee some of the details of it, how you arrived at certain things and so forth. It might be helpful for us to get that.

I was going to probe that with you a little bit, but I think it might be wise to use the time getting to some of the other general questions.

Peter Kinzler is my staff director. I think most of you at the table know him and, poor Peter, I'm going to expose him here a little bit. Other people cite unnamed people going out trying to do things. I've discovered that my staff director has tried to get a home equity loan and has gone out and apparently went through an elaborate process, spending countless hours going over and reviewing various options in the Greater Washington Area and finally settled on one particular institution, only to find out after he had gone over and spent about 25 hours of research, getting information, soliciting more and so forth, that the one particular place he chose held out the right for the unilateral changing of the contract which I've discussed earlier.

Nonetheless, you see there someone who is spending a lot of time and really soliciting a lot of information and with all of that still finds in the final analysis they haven't picked up everything.

Second, I'd like you to look at—I'm going to send this down to you to look at because this is just dazzling. We've spent time looking at this thing, but you've got to see this.

CONFUSING MONTHLY STATEMENT

This is a copy of a monthly statement for a home equity loan. Let me give it to you and then follow it with me, and maybe you can quickly explain this thing to me. But follow along with me, if you will.

At the very bottom it states the basis for determining the finance charge and the daily periodic rate times the average daily balance. In this case, the amount is $92.92. You see that finance charge to the right is the column going across second from the bottom right in the center, $92.92. Above that, it states the date of the last payment and says that $73.35 was "applied to finance charge." $73.35 is at the very top. Then it says below that of the $92.92 finance charge, $36.54 was for "payments during cycle applied to this cycle's finance charge." It then says $56.38 was a "finance charge due included and minimum payment due."

Now I stared at that sucker for a long time and I can't figure that one out for the life of me. This is what people get back. And if you're talking about an average person trying to figure out these things, isn't that confusing? Isn't there some way that thing could be stated in much more clear, concise terms so that you could look at it and maybe understand where the finance charges were coming from?

Mr. HARMAN. Mr. Chairman, I think this is confusing and I think that it's a perfect example of how we have to proceed carefully.

Senator DODD. I didn't make this up either. This is a real one.

Mr. HARMAN. I think it's a perfect example of how we have to proceed carefully with regulation because sometimes well-intentioned regulation which is intended to inform the consumer results in disclosure that the consumer can't understand. So, of course, the consumer's initial reaction is to just overlook the whole thing and just try to figure out how much he's supposed to pay. I think this is something that gives rise to great care on the part of legislators.

Senator DODD. Well, I'm not sure this is the result of regulation.

Mr. FERGUSON. Mr. Chairman, I don't want to be out on a limb with First American at this point, but it appears that it could be a typo in the sense that that $56.38 really should be $156.38 as up at the right-hand corner at the top, which would be the minimum payment due, and included in that was the finance charge.

Senator DODD. If you add all those together, you might get that.

Mr. HARMAN. Of course, regulation Z has extensive provisions regarding what information must be included on a periodic statement and I can't tell by looking at this——

Senator DODD. I won't belabor it. I just wanted to highlight a point I'm making because those kind of issues do raise problems. I understand and I agree with you. I think sometimes you get instructions for people or consumer protections and I can't read them any longer. I'm nearsighted, not farsighted, but I sit there and try and follow what we've obviously designed to protect the consumer and in many cases I think we overwhelm them to such a degree that you lose all interest. I think it's a very legitimate point, but these things ought to be done. And you may be right, but nonetheless, even if you get that, arriving at that thing is a rather confusing document to read if you're even a knowledgeable consumer and an interested consumer. That was really my point to you, if I could.

Let me raise a couple of questions to you as well. I'll try and do this fast.

You indicate, Mr. Ferguson, that the consumer can use the right of rescission to cancel a home equity loan at no cost. You don't suggest by that as well that the closing costs and other things would be reimbursed, or whatever percentage you might work out would come back. That's a pretty hefty cost for a lot of people.

Mr. FERGUSON. Well, that's true. But I think in many cases you will find that certainly in the environment we are in now that in most of these there are no closing costs. I think it's a no-cost deal in a lot of instances.

Senator DODD. Some of them are, the ones that highlight those, but I think it would be wrong to suggest that there is not a cost associated with just rescission.

You all sort of pointed out to one degree or another that there doesn't seem to be much of a problem here yet with the home equity loan and foreclosures.

The first obvious question that comes to me is that we've seen only recently this tremendous surge of activity. And since most of these loans we're talking about run for a 10- to 15-year period, isn't it correct to assume that we really don't know the answer to that yet? I'm not suggesting you're wrong, but it's far too early to suggest that we have any indication of how well consumers are going to be able to meet their financial obligations under these loans.

Do any of you disagree with that?

Mr. HARMAN. Well, Merrill Lynch has been in the business for 5 years. The rate or growth for our equity credit lines was no greater this year than it was before tax reform.

Senator DODD. I'm sorry?

Mr. HARMAN. Merrill Lynch has been in the business 5 years and our growth rate did not increase significantly this year over previous years.

Senator DODD. What is the term of the loans on the average, 10 to 15 years?

Mr. HARMAN. Ten years.

Senator DODD. So you've been there for 5.

Mr. HARMAN. And we've had loans outstanding for 5 years and have been fortunate, as I say, in having a very favorable foreclosure experience over this period.

Mr. Chairman, may I add, in response to a previous question, that regulation Z does require the lender to refund to the consumer all costs that the consumer has incurred if the consumer elects to rescind the transaction.

Senator DODD. At what point?

Mr. HARMAN. Excuse me?

Senator DODD. At what point, the rescission?

Mr. HARMAN. If the consumer rescinds within 3 days after signing the credit documents.

Senator DODD. Well, we're not talking about 3 days here. You can change the rules in 15 days. Fifteen days after you've established rules you can change them.

Mr. HARMAN. I'm sorry. I thought your question was——

Senator DODD. I know, but my point is, 15 days after you establish what the rules will be you are permitted to unilaterally change them.

Mr. HARMAN. Right, as to future advances.

Senator DODD. So that consumer on the 15th or 16th day doesn't get back the closing costs.

Mr. HARMAN. Right, although under our program he has the right to continue with the old terms on his existing balance.

Senator DODD. Obviously, different places do different things with this.

Mr. KIRKPATRICK. Mr. Chairman, to add weight to what Mr. Harman said, we've been in existence since 1982 also, not quite the number and volume since we operate only in one State, but our experience has been basically the same. We've always marketed the product as an economical, prudent means of borrowing for the consumer which the ABA has supported, and I think the numbers on usage and lower balances in relation to committed lines proves that consumers are using these prudently and wisely and not in a frivolous way.

Senator DODD. Well, as you all point out, you're dealing with a middle-income or upper-middle-income and beyond category that's going for these. So there's an education level and so forth. There may be some concern about whether or not you will just stick with that kind of a profile or whether or not it will expand and get down into an income category where there's going to be a closer call. That's all I'm suggesting.

I presume most banks—you don't want to own homes.

Mr. KIRKPATRICK. Obviously, that's correct.

Senator DODD. A lot of States allow you to. As you point out in your testimony, Mr. Harman, on normal consumer loans, unsecured loans, you run the risk of jeopardizing your home. That's true. There are an awful lot of States that make that awful difficult for a bank to get their hands on a home. They will let you grab everything else, but the home has been something that, by State statute and regulation, has been held pretty far away from the mitts of a lender as a general matter.

They're screaming at me here about votes, but there are so many questions I have.

The prime rate—you heard the Fed say the use of the board of directors situation will decide what that is. Do any of you have any difficulty with using the public indices?

Mr. FERGUSON. No, we use that currently now.

Senator DODD. I assume most of you do. Isn't that a better way to proceed generally?

Mr. KIRKPATRICK. The ABA supports using an internally generated prime. We've got no problem with that. But we go with a broader, sometimes six or seven composite menu, we would have to see what it is.

Senator DODD. I don't have any problem with that, just so they're public indices we generally can go on.

Would you quickly respond to the unilateral question, the one that raised the other issue about changing the rules? You heard Alan Fox talk from the Consumer Federation, the Fed, and two Congressmen speak, and you understand the problem people see with that and people up here on this panel see. The consumer is going out and incurring a pretty hefty financial obligation and I'm not suggesting people are going to go and dramatically, 180 degrees, change the rules just to take the consumer to the cleaners. You've got your problems as well when things occur that you don't control and you've got to take that into consideration as you look over what your obligations are to your investors and other people that you've got an obligation to.

But what can be done in that area so that you minimize what seems to be a very significant imbalance?

Mr. FERGUSON. Mr. Chairman, I think that anything that's arbitrary and capricious in the contract just shouldn't be there. That's our position on that and I think there's a fair amount of body of State law that makes you provide notice on something that would come up relative to term changes and give an opportunity for a person to get out of a particular loan situation into another one.

To carry that a little bit further, as both these gentlemen said and I think you have somewhat supported, obviously we're not in a position to be in the real estate business. We certainly want to be in a lending business, and foreclosures are not very attractive for anyone. So that kind of situation, if in fact we were put in that, if somebody wants out, we would dearly like to fix that loan. If we've got a matched funding scenario, it shouldn't be a problem for a lending institution.

Senator DODD. I'm going to ask you if you would give some consideration to something, whether it was report language or other things we might want to put in, that would be talking about—there are certain things that I would presume everybody would agree just shouldn't be allowed to be changed. There are other things that obviously you have to leave open and subject to some change based on what happens. Ten or 15 years in the kind of world we're living in today is a fairly risky environment.

But you might give us some suggestions on things that ought not to be subject to change without consent and so forth of the consumer in a contractual relationship like this. I'd be very interested if you had any thoughts on areas like that.

Mr. HARMAN. We did change our terms this past spring, when we reduced the interest rate in response to competitive pressures.

The other circumstance in which I could imagine a change in terms would be if our index, which is the prime rate, 5 or 10 years from now deviated significantly from our cost of funds. We might then feel that it was necessary to change the index from the prime rate to something else. Of course, for some borrowers they might pay less but other borrowers might pay more. That's the kind of flexibility that we would need.

Senator DODD. I apologize again and thank you for being so patient and staying. We will submit some additional questions but I'm being bugged by the cloakroom and I don't want to have you wait another 20 minutes until I come back. I think we can submit some questions to you and it will be a little easier on all of you.

Thank you for being here and I do commend the ABA for your package.

Mr. KIRKPATRICK. Thank you for your input.

Senator DODD. The subcommittee will stand adjourned until further call of the chair.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]

[Additional material received for the record follows:]

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disadvantages for consumers of home equity lines of credit. Furthermore, responsible lenders using prudent underwriting guidelines will not extend credit to applicants whose resources and credit history do not suggest an ability to satisfy credit obligations.

2. If a consumer defaults on a home equity credit line, the lender may begin foreclosure proceedings, which could lead to the loss of the consumer's house. In analyzing this potential scenario, it is important to bear in mind that the same result could occur if a borrower who is a homeowner defaults on a substantial "unsecured" loan or line of credit. This is because the lender would probably obtain a judgement against the borrower, file a judgement lien against the borrower's house, and execute on the judgement lien. Responsible lenders follow work out and credit counselling procedures, to avoid foreclosure. Finally, a number of the advantages of home equity credit lines identified above are a direct result of the fact that they are secured by the borrower's house.

How Merrill Lynch Equity Handles Home Equity Credit Lines

Merrill Lynch Equity offers its home equity credit lines on substantially the same terms to consumers in all forty jurisdictions in which it makes this product available. However, state law sometimes requires some variation in product terms. Merrill Lynch Equity brings this product to the public's attention through limited advertising and direct mail programs. In addition, Merrill Lynch Financial Consultants counsel those of their clients who might be suitable candidates for, and benefit from, home equity credit lines. The Financial Consultants advise Merrill Lynch Equity of clients who desire to apply for equity credit lines.

All of Merrill Lynch Equity's facilities and staff are located at two sites in Connecticut. Merrill Lynch Equity sends prospects who may be interested in equity credit lines information and applications, from these Connecticut sites. At these sites, Merrill Lynch Equity receives and processes completed applications, arranges for property appraisals and title searches, obtains credit reports and decides which applicants to approve for equity credit lines, and what amount is to be approved. Credit decisions are based both upon the applicant's verified income, resources and credit history, and upon the appraised value of the applicant's house and outstanding balance of any first mortgage.

Merrill Lynch Equity arranges for closings at the office of an attorney or title insurance company convenient for the borrower. After the closing, Merrill Lynch Equity services the equity credit lines. The servicing includes arranging for equity credit line checks to be honored when utilized by the borrower, and having monthly statements prepared and mailed.

Two areas of equity credit line lending which have raised questions in the past are the lender's right to change the terms of an equity credit line after it has been established, and the lender's right to cancel an equity credit line and to require that it be paid in full, prior to its stated maturity.

The loan documents used by Merrill Lynch Equity throughout the country require that, if Merrill Lynch Equity desires to change the credit line terms after the credit line has been established, Merrill Lynch Equity must give the borrower advance notice of any proposed change. If the borrower does not wish to accept the proposed change, the borrower can draw down as much of the credit line as he or she desires within a specified time frame, and then notify Merrill Lynch, in writing and within the specified time frame, that the borrower does not wish to accept the change. A borrower who does not wish to accept a change in terms may not draw down any more funds on the credit line after the borrower rejects the change, but the funds outstanding will continue to be governed by the original terms.

From a lender's point of view, it is important that the borrower be required to notify the lender within a specified time period if the borrower desires to reject the new terms. Otherwise, when the time came to implement the new terms, the lender would not know which credit lines to freeze and to continue to bill on the basis of the original terms, and which credit lines to begin billing on the basis of the new terms.

Merrill Lynch Equity's credit documents provide that the term of the credit line is ten years. The documents do not give Merrill Lynch Equity the right to terminate the credit line before the expiration of the ten year period, unless the borrower defaults on his or her obligations under the documents, or unless laws, regulations or agency or court interpretations which become effective (in whole or in part) after the date that the equity credit line is established significantly impair the operation of Merrill Lynch Equity's equity credit line program. An example which comes to mind of a law which might have this effect is a state law which reduced the usury limitation below the lower of Merrill Lynch Equity's interest rate cap or the usury limitation which was in effect when the credit line was established. Another example is a state or federal law or regulation which impaired Merrill Lynch Equity's ability to vary the interest rate, on the terms set forth in Merrill Lynch Equity's credit documents.

Accordingly, Merrill Lynch Equity could not terminate its equity credit line solely because a customer's financial situation deteriorated or the customer became unemployed.

Need for New Legislation

As indicated above, Merrill Lynch Equity supports full and fair disclosure to borrowers and potential borrowers in connection with all consumer credit transactions. Such disclosure enables the potential borrower to compare the various types of credit available, and to be informed of the basic terms of the available credit, before being irrevocably obligated on the relevant credit instruments.

The Truth-in-Lending Act and Regulation Z already require lenders to make extensive disclosures in connection with home equity credit lines. Specifically, Section 226.16 of Regulation Z requires lenders to make comprehensive disclosure of the terms of home equity credit lines, in connection with advertisements that state certain specified terms of the credit being offered; Section 226.6 requires extensive disclosures of the credit terms, before the first transaction is made under a home equity credit line; Section 226.7 requires further disclosures with each monthly billing statement; and Section 226.15 provides for a right of rescission. Other parts of Regulation Z regulate other aspects of home equity credit line transactions.

In addition, in those states where a lender is relying on the pre-emption of state law afforded by the Alternative Mortgage Transaction Parity Act of 1982 (Title VIII of the Garn-St. Germain Depository Institutions Act of 1982) in order to offer equity credit lines to borrowers, the lender must comply with the extensive additional disclosure requirements of the Comptroller of the Currency, the National Credit Union Administration Board or the Federal Home Loan Bank Board (depending upon the type of lender). Some types of lenders must comply with these disclosure requirements, whether or not they are relying on the federal pre-emption of state law.

Furthermore, some states require home equity credit line lenders to make additional disclosures to consumers.

Merrill Lynch Equity is concerned that the point may be reached (if it has not already been reached) where the various disclosures required by the various regulatory agencies with the commendable intention of assisting consumers, become so extensive and possibly duplicative, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures. Merrill Lynch Equity is also concerned about the cost to home equity credit line lenders, of complying with additional disclosure requirements. This expense might be passed on to the borrowers, resulting in higher costs to the borrowers, without a material improvement in borrower protection.

Some groups have advocated legislation which would go beyond assuring that consumers have full and fair disclosure regarding equity credit lines, and would regulate the specific terms upon which lenders could offer equity credit lines. These proposals would prohibit equity credit line lenders from utilizing terms which are common in conventional adjustable rate mortgage transactions.

Section 1204 of the Competitive Equality Banking Act of 1987 already requires that any adjustable rate mortgage loan originated by a creditor shall include a limitation on the maximum interest rate that may apply during the term of the mortgage loan. This legislation does not present significant problems for either borrowers or lenders, because it leaves the lenders free to set the interest rate caps at any level they choose. A borrower who desired a lower interest rate cap could select a loan from a lender which offered a lower interest rate cap. A lender which desired to offer other features and a higher interest rate cap, is free to do so.

Merrill Lynch Equity feels that the free market and the demand of borrowers for various products should determine what features lenders offer in equity credit line loans. This same free market, driven by consumer demand, has resulted in the availability of a variety of types of conventional variable rate mortgage loans which are attractive to both borrowers and lenders.

One area in particular in which commentators have called for further legislation is requiring lenders to set specific annual or lifetime caps on home equity credit line interest rates.

Merrill Lynch Equity believes that specific annual or lifetime caps on home equity credit line interest rates would be more harmful to both borrowers and lenders than would annual or lifetime interest rate caps on conventional variable rate mortgage loans. This is because borrowers could establish equity credit lines with annual or lifetime caps, but not draw the lines down unless interest rates rose significantly. If interest rates did rise significantly, so that the caps required that the equity credit line interest rates be significantly less than they would have been without caps (and less than market rates prevailing at the time), borrowers would have a great incentive to draw down funds on their equity credit lines.

Lenders would be paying high interest rates for these funds, but receiving the lower, capped rates. If the high interest rates continued, lenders would begin losing money.

This situation would have an adverse impact on availability of funds in the future, and on stockholders and any depositors of the lenders. If the lenders were federally insured, this situation could become costly for the federal insurers, and hence for all taxpayers.

This potential negative impact on lenders and the public is not nearly so severe in the case of caps on conventional variable rate mortgage loans, where the loan proceeds are advanced to the borrowers at the closing, and repaid by the borrowers over a number of years. This is because, in the case of conventional loans, the lenders would at least make some profit on the interest received during the period between the time that the loans were made, and the time that interest rates rose. Much of this profit would be unavailable to equity credit line lenders whose credit lines were capped, because, as indicated above, borrowers would not have the incentive to draw down heavily on capped equity credit lines, until such time as interest rates rose significantly.

Prudent lenders would not take these interest rate risks caused by capped equity credit lines, and instead would purchase some sort of interest rate hedges, in order to protect themselves from losses caused by rising interest rates. This would, however, be expensive, particularly if relatively low annual caps were required. The lenders would need to pass the cost on to the borrowers. The most logical way for lenders to recover some of these hedging expenses would be to charge borrowers significant up front fees for establishing equity credit lines.

Merrill Lynch Equity feels that it is important that all borrowers not be penalized by having to pay more for equity credit lines, merely because some borrowers may desire to pay more, in order to obtain equity credit lines with particular interest rate caps.

Reactions to H.R. 3011, the Home Equity Loan Consumer Protection Act of 1987

In general, Merrill Lynch Equity supports H.R. 3011, because it furthers the purpose of making full and fair disclosure to consumers regarding home equity credit lines, prior to the time that the consumers become obligated on a home equity credit line.

However, the disclosures required by this legislation, when combined with the disclosures already required, might result in such extensive disclosure, as to confuse the consumer and/or inhibit the consumer from actually reading and understanding any of the disclosures.

The chances of this adverse result to consumers occurring would be less if this legislation was revised so as to provide that the required disclosures were to be given in place of the disclosures required by other federal or state laws and regulations.

Reactions to H.R. 3468, the Home Equity Loan Disclosure Act of 1987

Merrill Lynch Equity supports the goals which this legislation is intended to achieve, and the disclosure provisions of this bill. However, Merrill Lynch Equity is concerned about the requirements regarding the terms upon which lenders may offer equity credit lines. These requirements could result in all borrowers paying significantly more for home equity credit lines, and could prevent borrowers from obtaining home equity credit lines on terms which might be appropriate for particular borrowers' circumstances.

* * *

Mr. Chairman, I would like to thank you for the opportunity to appear before your subcommittee today, and I would be happy to answer any questions you might have.

Statement
of the
National Council of Savings Institutions
on Home Equity Loans
Subcommittee on Consumer Affairs
Committee on Banking, Housing & Urban Affairs
United States Senate
November 18, 1987

The following statement represents the views of the National Council of Savings Institutions for today's hearings concerning various issues surrounding home equity loans.

The Subcommittee on Consumer Affairs is considering the question of the appropriate level of consumer protection necessary and is reviewing bills introduced in the House. The National Council supports the approach of Congressman David Price when addressing the consumer's need for proper disclosure of terms for home equity lines of credit (HELC). We do, however, oppose restrictions or limitations imposed on home equity lending programs which in turn could adversely affect lenders and the availability of the product for consumers.

Background

Home equity lending is an important refinement in the second mortgage products that our members have been offering consumers for some time. These loan products represent a healthy diversification of savings institutions' portfolios, since second mortgages are shorter term than first mortgage loans, and often carry variable rates of return. Second mortgages and home equity credit lines are financial products that today's consumer expects to find at leading providers of financial services.

As many institutions have attempted to diversify into consumer loan products such as car loans or credit cards, they have discovered a very

competitive, crowded market. In the case of automobile loans, for example, the competition from captive finance subsidiaries of auto manufacturers offering "advertised" rates as low as 1% is stiff competition indeed. Savings institutions are ideally suited to offer home equity credit loans since well established consumer relationships (through first mortgage lending) and mortgage lending departments are the foundation for good home equity lending programs.

Home equity loans act as revolving lines of credit in which a qualified homeowner may draw on an established account. The maximum loan amount is based on two factors: the percentage of equity built up in the home and the ability of the borrower to make payments. Typically, home equity loans are used for home improvements, education, medical emergencies, and the purchase of major consumer items such as boats or cars, among others. HELCs differ significantly from previous revolving lines of credit in the fact that these loans are secured by the homeowner's dwelling.

Home equity loans offer the borrower features not available with unsecured or traditional loans. The first important benefit is cheaper rates. Since the loans are secured by real estate, the borrower can get funds at more attractive rates than are available for signature or unsecured loans. The second major feature is convenience. Since the line of credit can be established at one time, and drawn down as the borrower needs the funds, it is easier for an individual to manage his or her debt than otherwise would be the case. This is a major benefit over the traditional second mortgage.

1986 Tax Reform Act

Another important feature of these loans was recently added through actions of the Congress when it restricted the deductibility of interest on certain loans. Home equity loans have received much attention in media markets within the short time following the passage of the Tax Reform Act of 1986. This tax law will phase out interest deductibility for consumer credit by 1991. One exception still remains, however, and that is the ability to deduct interest incurred on debt secured by a taxpayer's primary

EXHIBIT A

Don't bet the house on it.

Can you afford to sell your house today and spend the money on a vacation? Or a luxury car? Most of us can't.

Yet many consumers will soon run the risk of doing just that with home equity lines of credit.

The new Tax Reform Act of 1986 makes these loans a powerful credit tool for homeowners. Under the new tax law, interest on these loans will remain tax-deductible. The interest deduction for consumer loans such as personal, auto and credit card loans will start to phase out this year. By 1991, no tax deduction will be allowed for interest paid on these consumer loans.

These advantages make home equity lines of credit a desirable product for many borrowing needs. Some will argue that the tax advantages alone are reason enough to replace credit cards and other consumer borrowing tools with home equity lines of credit. But you need to understand the terms of such a loan before "signing on the dotted line."

Although home equity lines of credit offer the convenience of revolving credit card accounts, combined with tax advantages, there is a crucial difference. Your house — the most important investment you own — serves as collateral for the loan. Such a commitment should not be taken lightly.

There are other important differences as well.

- Home equity lines of credit involve much higher amounts, an obvious point. Yet the casual borrower could escalate credit spending beyond the family budget.
- Most equity lines of credit have 15-year terms, much longer than credit card accounts. The longer term, which usually means lower monthly payments, may also lull the casual borrower deeper and deeper into debt.
- The longer term makes it harder for you to predict your financial state throughout the period. What will your house be worth in 15 years? How much will you earn? Can you be sure of your health? Are you willing to bet the house on your guess?
- Home equity lines of credit, like fixed home equity loans, involve up-front closing costs and appraisal fees, which vary from lender to lender. Some institutions even charge the borrower points — or a percentage of the amount borrowed.
- If you want to increase your credit line later on, you may be required to pay the closing costs, fees and points all over again.
- The interest rates, which are usually linked to the prime rate, are more variable than credit card rates. And given the size of the potential interest payments, it pays to shop around before you sign up for a line of credit.

All of these differences demand that you approach a home equity line of credit as you would another mortgage (which it is) rather than another easy source of credit. We suggest these prudent borrowing strategies:

- Analyze your financial situation carefully before going to the bank. Consider your long-range financial plans and what role your home equity plays. For instance, are you counting on retirement income from the sale of the property?
- Apply for the amount of credit you can afford — and no more. Resist the temptation to think of a home equity loan as an easy cash reserve. You may also be tempted to apply for the maximum amount to avoid additional closing costs later. This may make sense, if you know you can manage the maximum line of credit.
- Adjust your payback period according to your purchase. It makes little sense to borrow money for a car and pay it back over 15 years. Even with the tax advantage, the car will cost much more than it would with a fixed-term conventional loan.

  Instead, calculate the amount of principal you need to repay each month to pay off the loan in a reasonable period of time, or ask your lending institution to do it. Then pay that amount along with the finance charge, rather than the minimum payment.
- Don't risk the family home for frivolous purchases. Although you may have always wanted to go on safari, ask yourself whether your house is worth a few snapshots of wild giraffes.

What are we getting at? Simple: Don't use this kind of credit to pay for things that are used up as soon as you buy them. They don't justify eroding your net worth — and that's what imprudent borrowing can do.

We hope you'll take these tips seriously when you apply for your home equity line of credit. GSB intends to work with you to structure a home equity line of credit that will meet your needs without endangering your home equity.

We know what your home means to you, both financially and personally. We want you to enjoy it for many years to come.

If you have questions or comments about home equity lines of credit, we invite you to write to:

Andrew McA. Hunter
Vice President
GSB
City Line & Belmont Avenues
Bala Cynwyd, PA 19004

GSB
GERMANTOWN SAVINGS BANK
SO MUCH MORE
Member FDIC

EXHIBIT B

THE ONE EQUITY LINE OF CREDIT

IT CAN HELP YOU HANDLE YOUR MONEY BETTER

We think you'll find The One Equity Line of Credit the most versatile, easy to use loan you've ever had. And in order to help you use this loan to your best advantage, we've enclosed some valuable information designed especially for The One Equity Line clients. No matter how you plan to use your loan, now or in the future, these cards will give you some helpful suggestions on how to best use your home equity. We hope you find them useful. If you have any questions now or later, please just give me a call!

BUILDING A SECOND HOME

The One Equity Line of Credit can help you finance the construction of a second home or other recreational property.

Before you start, here are some suggestions you may want to consider:

-If you are considering the purchase of a parcel of land to build on, be sure to check with the local building inspector to determine what information or documentation is necessary to be sure that the parcel is buildable.

-Before purchasing the real estate, you should also contact an attorney to conduct a title search on the property to be sure that you will have a clear and marketable title.

-Check you city or town's building code to be sure that your project will be in compliance with any applicable ordinances and zoning requirements. Be sure to determine whether you or your contractor will be responsible for obtaining any permits, licenses or other municipal approvals and then make certain they are obtained.

-Contact more than one contractor to get written bids. You may be surprised at the vast disparity in price and time to complete between contractors for the same job.

-Get references on each contractor from people they have worked for and make a visual inspection of recent examples of their work. You may prefer one contractor's style and quality over another's.

-Contact an independent appraiser or REALTOR to determine whether the value of the property, once you complete construction, will not represent an over-improvement for the area.

-Make certain you understand the terms of the contract you sign with the contractor, especially concerning progress payments, payment of subcontractors, and the timeline for the project. If you have any questions at all, see your lawyer before you sign.

-Protect yourself against liens for non-payment of subcontractors by receiving lien waiver agreements from the contractor and any subcontractors. This will protect you in the event that the contractor fails to pay the subcontractor.

-Do not make the final payment until you are satisfied that the work complies with the terms of the contract. If necessary, negotiate a "Hold Back" amount with the contractor to cover work which must be corrected or modified, including a scheduled completion date by which the contractor must complete the work or forfeit an agreed amount. By retaining a certain amount of funds, you will be in a better position to have the work completed satisfactorily by a different contractor.

PURCHASING INVESTMENT REAL ESTATE

The One Equity Line of Credit can help you finance the acquisition of investment property.

Here are a few items you should consider before undertaking this investment:

-In order to protect your interests, an attorney should represent you. Your attorney can also conduct a title search of the property to ensure that the title is clear and marketable.

-Before purchasing the property, ask the seller for operating expense statements on the property. This can assist you in determining the earning potential of the property.

-Engage an independent appraiser to appraise your proposed purchase in order to determine if you are paying fair market value. (Maine Savings Bank can suggest independent appraisers if the property is located in Maine.)

-Determine whether any property improvements are necessary immediately or in the near future and include their projected costs in your expense calculations. Be sure to include any additional borrowing costs as well.

-Have an accountant go over the income statements on the property to ensure that you are aware of all tax implications and that the property will be a profitable investment.

-If the property cannot support a professional manager, consider the cost and time necessary for you to travel to and manage the property yourself.

COLLEGE EXPENSES

Use The One Equity Line of Credit to help you finance college, graduate school or other higher education.

Consider these facts before tapping the equity in your home for such expenditures:

-Even though your income may not permit the full borrowing for a subsidized Guaranteed Student Loan (up to $2,625 annually the first and second year and $4,000 annually the third and fourth year) don't automatically assume you are ineligible. Be sure to investigate that possibility thoroughly first by contacting your Maine Savings banker to explore your borrowing options.

-Don't assume that student loan requirements and eligibility guidelines will be the same every year. Fill out the financial aid forms each year to determine eligibility for a Guaranteed Student Loan or any other scholarship or grant programs the college may offer.

-Depending on the institution, you may be offered an alternative borrowing source directly from the school, or the school may provide some incentive if you elect to prepay any or all of the expenses for a particular program.

-Or you may wish to consider the Parental Loan Program of up to $4,000 per year, or, for independent students, the ALAS Program of up to $4,000 per year for graduate students and $2,625 per year for independent undergraduate students. These loans' fixed rates and longer terms may help to make the cost of education affordable while holding part or all of your home equity in reserve. Again, check with your Maine Savings banker about these options.

INVESTING OR BUYING A BUSINESS

The One Equity Line of Credit can be used to help finance the expansion or acquisition of a business, to invest in stocks and bonds, etc.

Here are some suggestions if you use your home equity for such investments:

BUYING A BUSINESS

-If you're thinking of buying a business, several years' income statements and balance sheets of the business should be analyzed to determine the viability of the business, the market for the products and stability of its customer base.

-Review the company's business plan carefully to determine if it is reasonable and its goals achievable.

-An accountant should be called in to review the balance sheets of the business.

-Your own attorney should always be consulted to protect your interests in any transaction.

-If you are using your equity as only a portion of the cash investment required, factor into your business plan the cost of additional borrowing.

STARTING A BUSINESS

-The same considerations for purchasing a business apply to the evaluation process in the decision to start a new business (see above), but because of the relatively high failure rate in new businesses, extra caution must be exercised and there must be additional funds available either through an unused equity line or outside sources.

-We do not recommend using advances against an equity line to start a new business unless income levels as shown in the original application are continued in order to service the loan in the event the business is not successful.

OTHER INVESTMENTS

-Investment strategies can target short-term growth or longer-term retirement goals. Consider IRAs, Keoghs, or SEPP plans. Talk to your Maine Savings banker to find out which option is best.

-Neither stocks nor bonds nor mutual funds involve guarantees of return or appreciation. Consider the consequences of losses as well as gains before you invest.

-To invest in stocks, bonds, mutual funds or other similar investment vehicles, you may wish to contact Winslow Investment Company, a subsidiary of Maine Savings Bank, for both advice and discount brokerage services.

-Talk to the people at Winslow Asset Management if you're interested in having a personal financial plan designed and managed for you.

HOME IMPROVEMENTS

You can use The One Equity Line of Credit to finance a home remodeling job or other home improvements.

Here are some suggestions to get you started:

-Contact more than one contractor to get written bids on your home improvements. You may be surprised at the vast disparity in price and time to complete between contractors for the same job.

-Get references on each contractor from people they have worked for and make a visual inspection of recent examples of their work. You may prefer one contractor's style and quality over another's.

-Check your city or town's building code to be sure that your project will be in compliance with any applicable ordinances and zoning requirements. Be sure to determine whether you or your contractor will be responsible for obtaining any permits, licenses or other municipal approvals and then make certain they are obtained.

-Contact an appraiser, REALTOR or other Real Estate professional to determine if the improvements will actually add value to your property. You may want to think twice if such a real estate expert feels your improvement will "over-improve" your property for the neighborhood, making it difficult to recover your investment should you decide to sell.

-Make certain you understand the terms of the contract you sign with the contractor, especially concerning progress payments, payment of subcontractors, and the timeline for the project. If you have any questions at all, see your lawyer before you sign.

-Protect yourself against liens for non-payment of subcontractors by receiving lien waiver agreements from the contractor and any subcontractors. This will protect you in the event that the contractor fails to pay the subcontractor.

-Do not make the final payment until you are satisfied that the work complies with the terms of the contract. If necessary, negotiate a "Hold Back" amount with the contractor to cover work which must be corrected or modified, including a scheduled completion date by which the contractor must complete the work or forfeit an agreed amount. By retaining a certain amount of funds, you will be in a better position to have the work completed satisfactorily by a different contractor should there be a problem.

CARS, ANTIQUES, ART, YACHTS...

Use The One Equity Line of Credit to write yourself a loan to finance larger purchases.

Here are a few things you should consider when purchasing other assets such as antiques, art, collectibles, a car, boat, etc.:

-Shop carefully. Be sure you are paying fair market value for your purchase.

-If purchasing a depreciating asset such as a car, boat or recreational vehicle, consider paying down the principal part of the loan balance (as well as the interest) on a regular basis so it is totally paid back in a reasonable period of time. Otherwise you may eventually be left with an outstanding debt which is much greater that the depreciated value of the asset.

-Your Maine Savings banker can set up a monthly amortizing payment schedule in order that your loan balance is "paid down" as your purchase depreciates.

-If purchasing an appreciating asset such as high quality jewelry, art or antiques, you should have these investments appraised to determine their market value. This will help to ensure that you are not over-paying for your investments, making it difficult to recover your expenditure should you decide to sell them at a later date.

-Be sure to maintain adequate insurance on all of your assets. Contact an insurance agent experienced with your particular assets to help you determine whether your assets are adequately documented and protected.

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

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December 1, 1987

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing and Urban Affairs
Subcommittee on Consumer Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the NATIONAL ASSOCIATION OF REALTORS®, I would like to thank you for this opportunity to comment on the topic of consumer disclosures for home equity lines of credit. We request that this statement be included in the record for the hearing conducted by the Subcommittee on Consumer Affairs on November 18, 1987.

The NATIONAL ASSOCIATION OF REALTORS® strongly advocates the standardization and strengthening of disclosure requirements to consumers for all loan products that are secured by a consumer's residence, such as a home equity loan. The credibility and viability of such a loan product can only be preserved by assuring that a proper balance is struck between its marketability, its ability to provide liquidity to homeowners, and the potential for risk. One of our chief concerns for the viability of home equity lending is the consumer's risk upon entering into such an arrangement. Because of the numerous features and options available under different home equity lending plans, the NATIONAL ASSOCIATION OF REALTORS® believes it important for potential borrowers to be able to fully compare and understand all of the features of the various loan products available.

The NATIONAL ASSOCIATION OF REALTORS® has consistently taken a strong policy position in favor of the provision of adequate, proper, and meaningful consumer disclosures. We strongly believe that adherence to disclosure requirements should be monitored closely by the appropriate regulators, and abuses should be corrected as quickly as possible. All parties -- lenders, consumers, and REALTORS® will benefit from a strong disclosure mechanism. The REALTORS® goal for this issue is to ensure that borrowers are fully informed as to potential risks and costs when they are using their residence as security for a loan.

EQUAL HOUSING OPPORTUNITY

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

In the U.S. House of Representatives, a bill that closely achieves the goal of adequate, proper and meaningful consumer disclosure has been introduced by Representative David Price (D-NC) and is entitled the Home Equity Loan Consumer Protection Act of 1987 (H.R. 3011). The NATIONAL ASSOCIATION OF REALTORS® supports each of the provisions of this legislation and respectfully submits the following additional provisions which we believe will provide an even greater degree of consumer protection:

Disclosure Recommendations

A. The bill would require the Board of Governors of the Federal Reserve System to prepare an informational brochure to describe "open-end" credit plans secured by the consumer's dwelling and the terms and conditions on which such loans are generally extended, plus a discussion of the potential advantages and disadvantages of such plans. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure be distributed as early as possible, (i.e. when a potential applicant initially inquires about a loan), and that this brochure should be provided directly to the consumer). We propose this early disclosure requirement because we believe it necessary for the consumer to have the greatest amount of time possible to compare different home equity loan plans.

B. The bill would require lenders to disclose up-front how changes to the Annual Precentage Rate (APR) will be determined, including the possible timing of such changes, and the source of the index used to calculate the APR, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also report the lender's margin. The disclosure of the lender's margin (that is, the amount that the lender will charge to the borrower over the index rate) will afford consumers the opportunity to compare the prices that different lenders charge for their loan products.

C. The bill would require lenders to disclose up-front the amount of all fees to be paid by the consumer, including annual fees, application fees, and discount points, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also include the amount of any late payment fees that a consumer may be required to pay. We believe that this information is necessary so that the consumer is made fully cognizant of the total extent of his or her financial responsibility for the loan obligation.

D. If the home equity loan plan involves a variable rate feature, the bill would require lenders to disclose the maximum amount that the APR may change in any one year period. The NATIONAL ASSOCIATION OF REALTORS® recommends that lenders be required to provide the consumer with sufficient advance notice if the APR is going to change. The NATIONAL ASSOCIATION OF REALTORS® recommends that such advance notice be required no less than 30 days prior to the rate change. It is important to note that this recommendation is not intended for up-front disclosure, rather, this recommendation would require the lender to provide advance notice to the consumer, during the term of the loan, that the interest rate for the loan, and thus the payments, are going to adjust. We believe that such an "advance-warning" requirement will enable consumers to better manage their financial obligations.

E. If the home equity loan plan involves a variable rate feature, the bill would require lenders to disclose the maximum APR that may be charged in any one year period. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure also include the maximum amount that the APR may increase over the entire loan period.

F. If the home equity loan plan involves a variable rate feature, the bill would require lenders to demonstrate the actual loan payments for a sample $10,000 loan amount under the terms of the plan, The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure, rather than rely on the sample $10,000 loan amount, be prepared with the specific loan amount requested in the loan applicant's application. The Association is supportive of the conceptual framework of the proposed hypothetical example and we do believe that an example based on the actual history of the particular index is a reasonable approach to this disclosure, however, the Association believes that a specific disclosure will prove more useful to consumers in comparing variable rate loans. While the legislative proposal would require lenders to include a statement on the disclosure form explaining to borrowers how to calculate the example for their particular loan amount, we continue to believe that an example based on the consumer's specific loan amount is the optimal method. The experience in the real estate industry is that borrowers relate more easily to specific facts and figures. An example, not readily specific, will be less meaningful to consumers.

G. The bill would require lenders to disclose, if applicable, a statement that explains that although a borrower may be permitted to make interest-only payments on the loan, and that while such interest-only payments may cost less on a monthly basis, such a loan feature: does not retire loan principal; prolongs the obligation; and results in a greater total expense over the life of the loan. The NATIONAL ASSOCIATION OF REALTORS® recommends that this disclosure include an explicit statement that an interest-only feature, or a negative amortization feature can mean lost equity for the homeowner.

H. The bill would require that any advertisement for a home equity loan provide: the amount of any charges that may be imposed; the finance charge of the plan, expressed as an annual percentage rate (APR); the amount of any membership or participation fee that may be imposed; a statement that interest expense may not be completely deductible for all taxpayers; and, a prohibition on the terms, "Free Money", and "Loan at Prime". The NATIONAL ASSOCIATION OF REALTORS® recommends that if applicable, the advertisement should also disclose the amount of any potential, or scheduled, payment increases.

Conclusion

We hope that this information will be of assistance to you as the Subcommittee on Consumer Affairs conducts further hearings and deliberations related to this important topic. As always, please let us know if the NATIONAL ASSOCIATION OF REALTORS® may provide your subcommittee with any additional information.

Sincerely,

Stephen D. Driesler,
Senior Vice President

cc: Peter Kinzler, Counsel,
Subcommittee on Consumer Affairs
The Honorable David Price

and secondary residence, within the limitations of the 1986 Tax Reform Act.

When speaking about the ramifications of the Tax Act on the second mortgage markets, it is important to remember that only 37% of taxpayers currently itemize their deductions, and this number should go down after the new tax law takes full effect. However, the restrictions on tax deductions for traditional consumer loans have created a greater demand for an alternative product which will help consumers replace some of the tax advantages previously available for credit card, automobile, and other personal loans.

Recently, legislators and regulators have been concerned with borrowers' increased exposure to the risk of losing their homes due to an inability to repay the home equity loan. The National Council shares this concern. Clearly some of the hard sell advertising for home equity lending has been unfortunate, but it appears that such advertising is an exception, and not the rule. We are attaching for your review as Exhibit A an ad that one of our members, the Germantown Savings Bank, has used. This is representative of much of our membership's approach to this important financial product.

Need for Consumer Awareness

Because a home is the most important investment made by most, any loan agreement which could affect such home ownership should be thoroughly understood and assessed by the consumer. Another of the Council's members, the Maine Savings Bank, hands out a booklet with important practical advice to potential home equity borrowers. The entire text of the booklet is attached as Exhibit B.

It is important in today's increasingly complex mortgage marketplace that proper and understandable information be provided to any potential borrower. The National Council has supported past efforts to educate consumers on the mechanics of various mortgage products. In 1984, the National Council worked in conjunction with other industry trade groups, the Federal Reserve, and the Federal Home Loan Bank Board to develop the

Consumer Handbook on Adjustable Rate Mortgages. This consumer information brochure has proven to be the most useful tool in describing the ARM. We will continue to support similar educational efforts for home equity loans.

The Council recently sponsored a program for the industry on Home Equity Credit Lending, and placed a high priority on emphasizing the consumer's concerns in this line of business. We heard from Congressman Charles Schumer and a representative of Consumers Union to underscore the importance of the consumer's best interests.

Market Experience

As the Congress approaches the question of necessary consumer safeguards in the home equity lending area, it is important to keep certain things in perspective. First, the highly visible marketing of these programs is very competitive as providers of financial services attempt to maximize lending programs that many feel will be spurred on by the new tax law. However, a recent survey taken by the Survey Research Center (SRC) of the University of Michigan on behalf of the Consumer Advisory Council of the Federal Reserve shows that, "As of April 1987, 6% of homeowners had established lines of credit secured by their homes. In addition, 1% of homeowners had applied for such accounts but had not yet received approval."

The SRC survey also shows that, "Consumer awareness of the availability of HELC is high (80% of all homeowners stated they knew about such accounts). However, nine-tenths of homeowners who were aware of such accounts but had not yet applied for one stated that they were not interested in opening such an account in the near future."

Second, a major portion of the home equity lending business will represent a substitution of consumer debt transferred from credit card, automobile, boat, and other unsecured personal loans. This transfer of debt will represent a savings to the consumer in the form of cheaper borrowing costs. This is also borne out by the SRC study.

As the Congress addresses the issue at hand, the Council would urge that no restrictions be placed on the ability of lenders to structure loan products, as this will stifle market development. Since the introduction of home equity loans, there has been experimentation and product development by the industry in addressing problems that may still exist. As with any new mortgage-related product, there is bound to be the need for a revising and tightening of underwriting methods, marketing strategies, product design and proper disclosures for consumers.

ARM Comparison

If we simply look back a few years to when adjustable rate mortgages (ARMs) were the latest mortgage instruments, we can see many of the concerns addressed then resurfacing today with regard to home equity loans.

The early stages of ARM introduction met with borrower resistance. Few borrowers were willing to accept the ARM without protection against unrestricted interest rate increases. To remain competitive, creditors were forced by the market to adjust their product to include lower initial interest rates, annual and lifetime rate caps.

It cannot be overemphasized that a mutually beneficial ARM product for both lenders and borrowers must be developed without restrictions imposed by Congress and regulators. The outcome of extensive lending restrictions can be seen when reviewing the history of ARMs. Between 1978 and 1983, the Federal Home Loan Bank Board placed severe interest rate restrictions and disclosure requirements on ARMs, stopping many federally chartered savings and loans from offering the product because they could not remain competitive under those conditions. Although these restrictions were imposed to protect consumers, the effect was to prevent lenders from offering an adjustable rate product, thus denying consumers access to this type of financing. The major development in the ARM market came after the restrictive regulations were rescinded. In fact, the most popular ARMs contain consumer protections in terms of annual and lifetime rate caps, but these were developed by the market, not dictated by the government.

Today, consumers are becoming more sophisticated in their knowledge of new variable rate mortgage products. They are exhibiting extreme caution when undertaking large debt, especially debt which is secured by their homes. As was shown with the ARM example, borrowers will not accept a product which poses substantial risk. Lenders work to provide a stable and efficient instrument that reduces overall costs and minimizes losses due to foreclosure. It is not to the lender's advantage to offer a loan product which will be impossible for the borrower to repay. Foreclosure on a property can cause serious losses for both consumers and lenders.

We feel a market-determined home equity loan is the best solution to any problems arising today. We therefore urge Congress not to restrict lending practices, but to allow the market to dictate a workable home equity product. We wish to commend Congressman Price for introducing a bill which keeps a realistic perspective on the home equity lending market, and addresses potential problems through better informing the consumer and not through the imposition of arbitrary restrictions on the market.

The action taken by Rep. Price and the hearings being held by this Subcommittee are timely actions that will clearly help the regulatory process receive important Congressional input. In the near future, the Consumer and Community Affairs staff of the Federal Reserve is expected to submit to the Board for approval a proposed rule on open-end credit disclosure requirements. We look forward to working once again with the Fed staff in this area.

The National Council would like to thank the Subcommittee on Consumer Affairs for the opportunity to summit our statement on home equity loans and ask that it be included as part of the record for today's hearing.

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS WASHINGTON OFFICE
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PHILIP GASTEYER
Executive Vice President
& Director of Washington Operations

November 16, 1987

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Consumer Affairs
Senate Committee on Banking, Housing
and Urban Affairs
Room 534
Dirksen Senate Office Building
1st and C Streets N.E.
Washington, D.C. 20510

Dear Senator Dodd:

The U.S. League appreciates this opportunity to share with you and members of the Subcommittee our views on home equity lending. A review of home equity lines of credit is not only timely, but understandable and commendable. Because Internal Revenue Code changes will soon render home equity loans the only source of interest-deductible consumer credit, we have seen a considerable expansion of this type of lending. As a result, I do not doubt that there have been instances of their over-promotion and under-disclosure. Given the fact that home equity lending by its nature involves placing liens on consumers' homes, typically an individual's most important asset, we wholeheartedly agree that it is appropriate for Congress to review the area for abuse and explore whether existing consumer protection mechanisms are adequate.

We would point out at the outset, however, that proper disclosure of credit terms -- particularly regarding open-end credit, variable rate credit, billing error rights, advertising and the right of rescission -- is required under the Truth-in Lending Act. Further, we would note that Section 1204 of the Competitive Equality Banking Act of 1987 requires that all adjustable-rate mortgage loans, including home equity loans, must include a ceiling on the maximum interest rate that may apply during the term of the loan, effective December 9, 1987.

It is the League's view that most of the concern about home equity lending stems from fear about what consumers might do to damage themselves financially rather than from actual knowledge about what homeowners are doing in the marketplace. Our experience is that homeowners are approaching home equity credit in a cautious and conservative manner, and this appears substantiated by survey data developed in 1987 for the Federal Reserve Board by the Survey Research Center of the University of Michigan, and for the Consumer Bankers Association by the Center for Financial Services Studies of the McIntyre School of Commerce of the University of Virginia. For instance, the Michigan study showed that 80% of all home equity borrowers had used only 50% or less of their available credit line, and the Virginia survey, in looking at variable rate borrowers, found the average person had accessed no more than 57% of his or her contractually available home equity credit. Indeed, many borrowers seemed to regard their home equity line as a special or even emergency credit source. This is reflected by the fact that home improvements were cited by both studies as the most frequently mentioned use of borrowed funds, and by the finding of the Michigan survey that, when asked, 31% of respondents reported no use of the credit line, more than 50% indicated no borrowing in the previous six months, and 20% showed only a single instance of borrowing.

The survey data reflected care on the part of lenders in granting home equity credit lines. The Virginia survey revealed that loan-to-value ratios approved for variable rate home equity loans, including the first mortgage balance, average less than 70% -- a very prudent approach to underwriting. Prudent underwriting also was revealed by that survey's profile of the typical borrower: an individual between 35 and 49 years of age, earning $44,000 annually, who has been a homeowner for over 9 years.

That prudence and restraint on the part of both borrowers and lenders are the hallmark of the home equity credit arena is perhaps best illustrated by the very low incidence of delinquency and foreclosure revealed by the Virginia study. Delinquencies were 30% less than for all consumer debt, and the institutions surveyed averaged only 1.5 foreclosures annually.

These figures do not bespeak abuse. Rather they underline one of the central economic facts of home equity lending: Namely, that lenders like this line of business because the set of borrowers basically is self-selected for quality. People who have built up home equity against which they can borrow are, on the average, fiscally conservative people who can be relied upon not to attempt to shoulder undue financial burdens that ultimately may prove damaging to themselves and their creditors. It is this quality factor, buttressed by intelligent underwriting, that is the lender's primary economic safeguard in this context -- seeking to recover a debt through foreclosing on a mortgage lien, especially a junior lien, is an expensive, time-consuming and acrimonious process.

Under these circumstances, we strongly feel that the most appropriate Congressional response is to ensure that disclosure mechanisms are in place that will assure that consumers of this financial product have the information they need to make an informed decision. The U.S. League would oppose steps that would be aimed at dictating other aspects of the home equity loan relationship, such as legislating specific rate caps, banning termination clauses, establishing maximum loan-to-value ceilings and forbidding negative amortization. The marketplace, drawing on clear and meaningful disclosures, will generate a far more useful and flexible product range for consumers than would emerge from a regime of statutorily dictated contractual terms.

We would object in particular to any legislation establishing specific interest rate limits for home equity loans, whether in terms of dictating the number of basis points by which rates could increase, employing an approach allowing rate adjustments to apply only on a go-forward basis, or mandating the duration of initial rates. The marketplace for financial services is a very competitive one, and, as long as consumers have adequate information available, they will find suppliers of products suited to their needs. In the home mortgage field, for example, fixed-rate instruments remain a fixed presence, notwithstanding the dire predictions of those who resisted the authorization of adjustable-rate loans.

Indeed, we believe that the widespread popularity of adjustable-rate mortgages in the past four years made homeownership a reality for many American families who could not otherwise afford mortgage credit -- thus making a very significant contribution to housing's recovery from the 1981-82 spiral of interest rates. As you know, adjustable-rate loans are marketed at a significant entrance discount over fixed-rate mortgage loans. According to estimates of the U.S. League's Economics Department, as many as 1.4 million more new and existing homes were sold in that period than would have been sold if only fixed-rate mortgages had been available to homebuyers.

It should be emphasized that, in a marketplace where the interest rates on deposits have been deregulated, it would be a serious mistake to return to the practice of legislatively restricting, in effect, depository institutions' return on assets. We in the thrift industry paid a severe price for this sort of one-sided financial regulation in the past. Please bear in mind that financial controls of this kind, in addition to damaging suppliers of credit, also harm those who must consume it, for such restrictive practices invariably limit the availability of credit and increase its cost. The only individuals who profit are those persons who reap the windfall benefit, ultimately subsidized by others, of enjoying financing terms inconsistent with changes in market conditions.

Regarding the termination clauses, we would note that such provisos are long-standing features of open-ended consumer credit arrangements, and are a necessary safeguard for creditors. Initial credit-line authorizations in open-end home equity lending may lay dormant for several years before being exercised by the borrower, during which time the condition of the underlying property securing the loan or other circumstances may change materially. We regard the abuse of the termination clause as highly unlikely, given state law protections and the general difficulty, expense and bad publicity associated with the foreclosure process.

As noted earlier, loan-to-value ratios in home equity credit extensions appear to be at very prudent levels; accordingly there seems to be no evidence adequate to justify legislating in this area. In any event, we believe quite firmly that lenders and consumers are far better equipped than any government body to decide what proportion of a borrower's home equity prudently may be tapped to satisfy his or her credit needs.

Likewise, the negative amortization issue is one best left to the good judgment of the parties to the transaction. In some cases, a transaction that involves a degree of negative amortization, all things considered, may be the one best suited to the consumer's particular needs. We see no virtue in interfering with persons wishing to enter into such arrangements, particularly in the absence of a record of abuse.

Given our concerns about unnecessary and counterproductive governmental intrusion into the home equity lending process, we believe any legislative initiatives in this areas should focus on disclosure, reflecting traditional Congressional preferences. Our preference, however, would be for Congress to defer any legislation at this time in light of the Federal Reserve Board's ongoing efforts in this area. Congress should not lose sight of the fact that the Truth-in-Lending Act, as administered by the Federal Reserve, has proved to be a powerful, dynamic and flexible tool for assuring informed consent. In particular, we note that Congress, in the form of section 125 of that Act, has mandated a right of rescission applicable to home equity loans secured by the borrower's principal dwelling. Consumers are given a three-day period during which they can back out of such a transaction without charge, should they change their minds. This right, together with current disclosure authority, strikes us as representing an adequately protective regulatory regime.

In developing disclosure requirements, we would hope this Subcommittee would be mindful of the existing Truth-in-Lending requirements in Subpart B of the Federal Reserve's Regulation

Z. We strongly urge that the Subcommittee work with the Federal Reserve to assure that any new legislation does not overlap with existing law and generate redundant and expensive new paperwork requirements. Not surprisingly, these disclosure burdens fall most heavily on the smaller, neighborhood and community institutions.

As a second matter, we urge that any special disclosure requirements should apply only to the borrower's principal residence. The particular concern in Congress over home equity loans strikes us as centering on the possibility that an individual in default may lose his home. We suggest that the possibility of losing investment or vacation property is not an issue meriting special attention within the Truth-in-Lending context.

A third point of concern involves disclosure timing. We suggest that requirements for disclosure for home equity loans be made consistent with those governing closed-end credit, thus allowing consumers to obtain all relevant information at one time. This could be accomplished by requiring the home equity line disclosures to be made before the first transaction or within three days of the application, whichever is earlier.

In this regard, but as an aside, the U.S. League has long felt that the best point for Truth-in-Lending disclosures in the chain of events in a home purchase may well be when the prospective purchaser receives the professional services of the real estate agent. That is often the point when credit is arranged. It continues to strike us as remarkable that, by law (as provided by section 702 of the Garn-St Germain Act), real estate agents are exempted from consideration as "arrangers of credit." While we appreciate that home equity loans occur after the time of initial purchase, it is our view that the more general question of the appropriate time for disclosure deserves your Subcommittee's attention in the general context of Truth-in-Lending.

Our fourth suggestion is that any legislation be adjusted to limit to the application stage the "conspicuous segregation" requirement relating to the new home equity disclosures. This would reduce the need for extensive and expensive changes in standard disclosure statements, without sacrificing disclosure effectiveness.

Finally, we believe that existing advertising requirements are adequate to curb abuses in this area.

In conclusion, Mr. Chairman, we believe this product is proving to be a very useful one for both lenders and borrowers, enabling the latter in particular to have more convenient access to their most significant asset -- the equity in their homes. While we are confident that on the strength of the record of this hearing you will be content for the time being to let the Federal Reserve deal with the situation under existing law, should the case be otherwise, we would be privileged to work with you to strengthen disclosure requirements.

Again, the U.S. League appreciates this opportunity to provide the Subcommittee with our views. If we may be of any further assistance, please feel free to contact me.

Sincerely,

Phil Gasteyer
Executive Vice President &
Director of Washington Operations

Statement of

David H. Pohl
Senior Vice President
Gibraltar MoneyCenter, Inc.
San Diego, California

For The

American Financial Services Association

Before The

Subcommittee on Consumer Affairs
Of The
Committee on Banking, Housing and Urban Affairs
United States Senate

On

Home Equity Lending Practices

November 18, 1987

Mr. Chairman, Members of the Committee, I am David H. Pohl, Senior Vice President of Gibraltar MoneyCenter, Inc. of San Diego, California, and Chairman of the Real Estate Lending Section of the American Financial Services Association (AFSA)*.

I appreciate the opportunity to have our views on home equity lending placed in the hearing record. I would like, first, to define some of the terms which are commonly used to describe home equity lending; second, to discuss some of the criticisms of home equity lending products and third to discuss how these products are regulated.

Home Equity Loans - Definitions

The term "home equity loan" refers to any loan secured by residential property other than the primary loan to purchase the property. Although many believe that home equity lending is a relatively new phenomenon, its roots can be traced to the late 1800's when building and loan societies used this method to help people buy homes. Home equity lending has long been a major type of lending for many AFSA member companies. However, the predominant form of home equity lending was and still is the closed-end, fixed-rate loan, also widely known as the "second mortgage". Only within the last few years have more and more lenders begun to offer open-end home equity lines of credit.

In numerous recent articles and discussions on the subject, broad-brush characterizations have been made about all home equity loans. Quite often, no effort is made to distinguish the closed-end, fixed-rate loan (the traditional second mortgage) from the relatively new open-end home equity lines of credit. These types of loans have inherently distinct characteristics, but are similar in the respect that they are loans secured by the owner's interest in residential real estate. Both fall into the generic category of "home equity loan".

To maintain consistency throughout this testimony, I will use the following terminology:

TERM	DESCRIPTION
Second Mortgage:	Closed-end fixed-rate or variable rate loan secured by consumer's dwelling.

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*AFSA is the nation's largest trade association representing nonbank providers of consumer financial services. Organized in 1916, AFSA represents a diversified group of companies ranging from independently-owned consumer finance offices to the nation's largest financial services, retail and automobile companies.

TERM	DESCRIPTION
Home Equity Line of Credit:	Open-end, variable rate or fixed-rate loan secured by consumer's dwelling, which can be accessed by cash advance, check or credit card.
Home Equity Loans:	Generic term describing second mortgages and home equity lines of credit.

Over the last decade, home equity loans have become increasingly popular. For example, among a representative sampling of AFSA members, home equity loans outstanding grew from $2.4 billion in 1977 to $15.9 billion in 1986.

More recently, home equity lines of credit have caught consumers' imagination as more financial institutions offer these products. The 1980 technical amendments to the Truth-in-Lending Act, which made revolving credit products feasible, made their growth possible. Home equity lending has skyrocketed from $5 billion in outstanding loans in 1971 to over $150 billion in 1985 (according to data published by the Federal Home Loan Mortgage Corporation). According to Moebs Services, a Lincolnwood, Illinois research firm, outstandings exceed $225 billion.

Consumers like home equity lines of credit because they provide a relatively inexpensive and readily accessible source of funds. Consumers can borrow as much or as little as needed depending on the size of their credit line and the minimum advance requirements set by the lender. According to a recent Federal Reserve Board survey, conducted by the University of Michigan's Survey Research Center (the Fed-Michigan survey), consumers most often use home equity lines of credit to consolidate debt, make home improvements, purchase automobiles and to defray educational and medical expenses.

These products provide a source of credit which "travels" with the homeowner, thereby ensuring a reliable, easy, and low-cost method to gain access to funds when needed.

Financial institutions like home equity lines of credit because they historically have a low delinquency rate and, because of their large size in comparison to other consumer loans, have a lower cost to loan-dollar ratio. Home equity lines of credit attract a more upscale and sophisticated customer who may continue to utilize other services offered by the financial institution.

While AFSA's traditional membership - consumer finance companies - have been involved in home equity lending for a long time, it still is a fledgling product line in other sectors of the financial services industry. From AFSA's viewpoint, our competitors are only now learning what we have known for years --

that home equity lending is both attractive and beneficial to consumers as well as safe and profitable for financial institutions.

In fact, the soundness of home equity lending is clear. For example, in contrast to personal loans at finance companies, second mortgages show much lower delinquency and default characteristics. AFSA research department data showed that 1.79% of finance companies' home equity loans (primarily traditional closed-end second mortgage loans) were more than 60 days delinquent. By comparison 60 day delinquency in unsecured lending was 4.15%.

To further illustrate the lower delinquency of home equity lending, the U.S. League of Savings Institutions' 1986 Consumer Lending Survey showed 0.8% of noncredit card-accessed open-end equity loans and 2.3% of credit card-accessed open-end equity loans were more than 30 days delinquent. Delinquencies for first mortgage loans are running much higher. The Mortgage Bankers Association's national delinquency survey reported that 5.33% of all one-to four-unit residential mortgage loans were more than 30 days delinquent as of December 1986.

The variable rate feature that characterizes most home equity lines of credit is an added attraction to lenders seeking to protect their portfolios from periods of volatile interest rates.

AFSA Supports Consumer Education

Naturally, AFSA is very concerned about advertising and lending practices which may reflect adversely on the integrity of this business. For that reason -- AFSA supports full, clear and accurate disclosure of home equity loan terms, in a manner that is meaningful to both the borrower and potential borrower.

Beyond supporting the objectives of the Truth-in-Lending Act (TILA), AFSA has taken steps to contribute to consumer awareness of the nature of these products.

AFSA is conducting a consumer education program which alerts consumers considering applying for a home equity loan:

- o That such loans entail a security interest in one's home.
- o That variable rate and payment plans should be analyzed to see how they fit in one's household budget.
- o That consumers should seek competent tax advice.
- o That consumers should shop for the terms and conditions which best meet their needs.

This program has received wide-spread attention in the press. (*See* appendix)

AFSA upholds a Code of Ethics, a condition of membership in the Association, that emphasizes complete and accurate advertising and disclosure of loan terms. Two provisions of the Code are particularly appropriate:

- o Members will explain fully to customers the cost, terms, and contractual obligations of credit transactions. Written instruments will be as simple, lucid, and unambiguous as circumstances will permit.
- o Truth in advertising will be the guiding principle of all promotional efforts thus enabling potential credit users to make an intelligent marketplace decision.

Additionally, the Federal Trade Commission, which remains the primary federal regulator of most AFSA members, has given AFSA permission to reprint and distribute copies of their manual "How To Advertise Consumer Credit". In sum, AFSA is mindful of consumer information, advertising and disclosure practices in promoting home equity loans and continues to advocate adherence to such standards.

Home Equity Lending Under Fire

Recently, two consumer groups have called on Congress to enact increased disclosure requirements for home equity loans. Their proposed measures would also prohibit balloon payments and negative amortization plans. AFSA believes that these proposals are based on the following implied assumptions:
(1) there is a widespread problem with disclosure and advertising by financial institutions offering home equity loans; (2) consumers are too unsophisticated to understand the consequences of their actions; (3) lenders do not disclose terms and conditions in order to gain ownership of the security; and (4) home equity lending is now substantially unregulated.

These assumptions are false.

Lenders Disclose Terms And Conditions And Comply With Advertising Standards

Lenders comply with a host of state and federal disclosure statutes and regulations. If anything, we are now approaching the point where consumers are being confronted with "over-disclosure". In each home equity transaction, a borrower is given a voluminous amount of paper work. As described later, disclosure requirements are already prevalent for home equity lines of credit on the federal and state levels.

Advertising of home equity lines of credit has especially irritated consumer groups. One group stated in a May 11, 1987 press release that "banks are heavily promoting these credit lines by promising the good life with easy repayment terms. But instead, they'll keep consumers in a perpetual state of debt and eat away at the major source of consumer savings, the equity in the home."

Naturally, advertising is designed to sell products. The question is whether eye-catching ads encourage inappropriate financial behavior. No evidence has been proffered to suggest that advertising has produced any frivolous behavior with respect to actual uses of home equity lines. Further, no responsible lender condones misleading advertising. The recent Fed-Michigan survey indicates rational uses of the lines of credit by borrowers.

Consumers Are Sophisticated Borrowers

The consumers who enter into home equity transactions are sophisticated enough to understand the ramifications of the transactions. They understand that the loan is secured by their home; they understand that variable rates mean variable terms and they understand the tax consequences.

The American Banker newspaper reported in its May 12, 1987 edition that "consumer groups contended that many homeowners fail to understand the risks of home equity loans or to appreciate fully that they could lose their homes if they default on the loans." However, the consumer groups' press releases do not offer any support for this contention.

Even a casual reading of advertisements or the trade name of the products themselves, typically "home equity access account" or "home equity line", indicates that a home is involved. The TILA requires ample disclosures, discussed below, and provides for a three-day right of rescission.

Furthermore, the nature of the transaction with the need for appraisals, mortgage documents, and the like is similar to the consumers' initial mortgage application and closing process.

Recent data indicate that home equity line holders are sophisticated consumers. While AFSA research department data show that approximately 80% of traditional second mortgage borrowers have annual incomes of less than $36,000, the Fed-Michigan survey found that equity line holder's median education was 14 years with a median income of $40,000 and median home equity of $70,000. This appears to be hardly a group which would "fail to understand the risks of home equity lines", as the consumer groups contend.

The Fed-Michigan survey respondents were asked whether enough information was provided by the lender at the time the account was opened. Over 90% of the line holders reported they had received all of the information they needed to make an informed decision.

Lenders Are In Business To Make Loans

Lenders have no desire to enter into transactions which lead to foreclosures. In fact, lenders will do everything possible to inform borrowers about the product in order to avoid any future problems. In deciding whether to grant such loans, lenders evaluate the creditworthiness of the applicant -- whether that person has the willingness (shown by past credit history) and the ability (shown by income) to repay the loan. A practical reality in the home equity lending business is that lenders have no desire to foreclose on a secured property. In most cases, foreclosure proceedings lose money for the lender.

Home equity lenders are in the lending business -- not the real estate business -- and are in business to make viable loans which a customer will renew.

Finally, if the borrower does encounter difficulty with meeting his obligations, responsible lenders will generally attempt to restructure the loan to avoid foreclosure.

Home Equity Lending Is Highly Regulated

Financial institutions' advertising and the offering of these products must comply with a myriad of state and federal laws. For example, the following is a brief summary of applicable laws that a lender must consider before launching a home equity loan program.

The TILA (and Regulation Z which implements the Act) applies to any consumer transaction secured by real property used or expected to be used as the consumer's principal dwelling.

Two provisions directly relate to the initial disclosure statement required by Regulation Z. One requires that special disclosures be made for variable interest rate products. A lender offering a variable-rate product must disclose, in the initial disclosure statement, circumstances under which the rates may increase, any limitation on the increase, and the effects of the increase. The second provision permits the exclusion of certain closing costs from the finance charge (as in all real estate secured transactions).

Regulation Z governs home equity loan advertising. The open-end credit advertising rules provide that the use of certain terms trigger a requirement to disclose certain other key fees and charges that may be assessed in connection with a lender's credit program. One term that triggers these additional disclosures is that which indicates that the lender would, in granting the loan, acquire a security interest in the borrower's home.

Perhaps the most dramatic TILA provision is the consumer's right to rescind the entire transaction within three business days. This applies when the credit plan is opened, when a security interest is increased to secure an existing plan, or the credit limit of the plan is increased.

The right to rescind exists for three business days following the last of three specified events. These events include the occurrence which gives rise to the right of rescission, the delivery of the rescission notice required under the provision, or the delivery of all "material disclosures". If a lender fails to comply with these requirements, the borrower retains the right to rescind for a period of up to three years. A borrower may waive the right to rescind only in a bona fide personal financial emergency.

The Equal Credit Opportunity Act (and Regulation B which implements the Act) also contains detailed rules about information that a lender can request from an applicant for a home equity loan.

Disclosures required under state law also generally apply to a federally-chartered or insured lender's home equity loan program unless the required disclosures conflict with federal law.

State disclosure requirements affect almost every phase of a home equity loan transaction. For example, at the application or preapplication stage, special disclosures similar to the initial disclosures required by the Office of the Comptroller of the Currency's ARM regulation and the Federal Home Loan Bank Board's regulations may be required concerning the terms and conditions of the home equity loan.

Similarly, state "plain English laws" may govern the transaction. Certain terms, such as a due-on-sale clause, may be required to be disclosed in particular documents to be effective. Further, advance notices may be required of adjustments in the interest rate on the account. Finally, disclosures peculiar to delinquent accounts may be required under state law, such as "right to cure" notices prior to the acceleration of any outstanding account balance and special disclosure requirements prior to the initiation of foreclosure proceedings. In addition to disclosure requirements, state laws may address fees and charges.

The marketplace -- through the operation of the secondary market -- exerts a disciplinary force on lenders by encouraging the standardization of documents and underwriting standards. Although the secondary market for equity loans is not yet fully developed, it has and will continue to have an increasing influence on lenders' programs. These standards provide an incentive to use prudence in all aspects of home equity lending. After all, the bottom line for the secondary market is to ensure a minimal amount of loan defaults. Disciplinary forces exerted by the secondary market should not be discounted in determining the need for further regulation of this industry.

No Data Support Additional Legislation

Other than anecdotal citing of "horror cases", no major study has been undertaken to show the need for additional regulation. Many homeowners enjoy the benefits of home equity products. No evidence has been advanced that further protective legislation is required.

As discussed earlier, home equity lines of credit are a relatively new innovation available to consumers. As such, evidence is just beginning to be assembled on the scope of the home equity lending business such as, how many financial institutions are offering the product, how many consumers have utilized the product and to what extent have the lines been exercised. It was only in July of 1987 that the Federal Reserve Board began to collect separate data on the amount outstanding extended under home equity lines of credit by banks.

While efforts are continuing to collect and analyze as much data as possible, it may be too early to draw vast conclusions about any aspect of open-end home equity lines of credit.

All available evidence suggests that consumers are pleased with home equity lines of credit and have not encountered any significant problems with them.

AFSA believes that this Committee should consider additional legislation only if such legislation does not inhibit the positive growth of home equity lines of credit.

Conclusion

AFSA is willing to work with your Committee in addressing these concerns. Thank you, Mr. Chairman and Members of the Committee, for this opportunity to file this statement for the record.

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